PERFORMANCE AUDIT

STATE COMPENSATION FUND

Report to the Arizona Legislature
By the Auditor General
December 1988
88-10

AUDITOR GENERAL
REPORT SUMMARY

December 1988 Report No. 88-10

The Office of the Auditor General has conducted a performance audit of the State Compensation Fund in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§ 41-2351 through 41-2379.

All employers with one or more employees must provide workers' compensation insurance for their employees. The State Compensation Fund is the major provider of workers' compensation insurance in Arizona. Fund policyholders account for approximately 60 percent of all workers' compensation policies in the State. The Fund was established as part of the Industrial Commission in 1925 and became a separate agency in 1969. For calendar year 1988 the Fund has 689 authorized positions and an operating budget of approximately $34.3 million. The Fund's 1987 financial statements reported assets of more than $659 million.

The Fund Is A State Agency Subject To Legislative Control

Arizona law clearly establishes the Compensation Fund as a State agency and the State is liable for losses sustained by the Fund. The Fund's status as a State agency gives the Legislature broad authority over the Fund, including the right of termination under the Arizona Sunset Law.

Because the Fund is a State agency, the Legislature may arguably have some control over the Fund's assets. For example, terminating the Fund might allow the Legislature to distribute the Fund's assets. Once all outstanding claims against the Fund were resolved the Legislature could argue that any remaining funds belong to the State because the Fund is a State agency whose liabilities are backed by the State. However, the Legislature's authority beyond this point is uncertain. No law authorizes the sale of the Fund. However, recent court decisions in New York and Oregon might support a Legislative attempt to appropriate some of the Fund's surplus without terminating the agency, but Arizona case law is unclear on this matter.

If the Legislature wishes to consider terminating the State Compensation Fund and/or transferring some of the Fund's surplus to the General Fund, it should obtain further legal research on the potential consequences of such action.

The Legislature Should Evaluate The State's Relationship With The State Compensation Fund

The need for the Compensation Fund and its role in providing workers' compensation insurance has changed since the Fund was established in 1925. The Fund was initially intended to insure all employers, and in particular those employers unable to obtain insurance elsewhere. However, the Fund is no longer required to insure employers, and is now one of more than 100 companies in Arizona competing in the workers' compensation market.

Although the Fund no longer serves as an insurer of last resort, it continues to benefit from its past and present relationship with the State. The Fund accumulated substantial reserves between 1926 and 1968 when the Industrial Commission allowed it to charge rates 10 percent below other insurers. These reserves provided sufficient investment income to allow the Fund to sell policies at lower costs and offer yearly dividends after it became a separate agency in 1969. As a result, the Fund has maintained a sizable market share and the reserves needed to adequately fund this share continue to enable the Fund to offer lower prices and dividends. Thus, the Fund continues to enjoy a competitive advantage over private insurers. In addition to this advantage, the Fund saves approximately $2.4 million annually because it pays no Federal income tax and is not required to establish the security deposit required of other insurers. The Fund saves another $1.4 million each year by purchasing goods on State contracts and participating in the State personnel system, risk management and cash management programs.

The Legislature should consider reducing the Fund's competitive advantage by requiring it to: 1) pay the equivalent of its Federal income tax liability to the General Fund, and 2) reimburse the State for the full cost of all services paid for by General Fund appropriations. The Legislature should also review the need for the Fund and determine whether the State should compete with private insurers.

Claims Management Could Be Improved Through Private Sector Procedures

The Fund does not employ procedures commonly used by private insurers to manage claims. Unlike most private companies contacted by Auditor General staff, the Fund does not assign cases so that more experienced staff handle more difficult, complex cases. Procedures for managing claims are also weak compared with private insurers. Supervisory review of claims is limited, investigations are often not thorough or timely, and the Fund does not use enough medical personnel to manage medical aspects of claims.

Failure to manage claims can result in unnecessary costs and, consequently, higher premiums for policyholders. For example, a claims representative did not investigate discrepancies in claims information or follow up on medical reports that indicated a claim was not valid. As a result, the Fund paid almost $90,000 for unnecessary treatment. In another case, the Fund authorized questionable surgery that resulted in $99,000 of unnecessary medical and compensation costs.

Access Control And Disaster Recovery Procedures For State Fund Data Processing Are Weak

Although the State Fund relies heavily on its electronic data processing (EDP) system for many operations, controls are weak in two critical areas. The Fund has not established effective controls such as passwords, operations logs and physical restrictions to protect EDP operations and programs from unauthorized access. Lack of control increases the risk of fraud and abuse. In addition, the Fund has not developed adequate plans to ensure continued operations in the event of a disaster. The Fund has an informal agreement with another organization to use its computer but has not determined how much time would be available, frequency or duration of use.

Some Actions Have Not Been Fiscally Responsible

The Fund has demonstrated questionable fiscal responsibility in some areas. Recent building acquisitions did not comply with statutory requirements because the Fund did not submit capital outlay plans to the Joint Legislative Budget Committee or obtain appropriate authorization from its Investment Committee. In addition, some expenses from the Fund's annual training programs seem extravagant. The Fund spent more than $113,000 in 1987 and 1988 for two training institutes. Expenditures included meals, lodging and arrival gifts for out-of-state guests; lodging for employees not on travel status; and gifts of watches, luggage and leather attache cases for some employees. Some of these expenses, especially the gifts, may violate constitutional and statutory restrictions on use of public monies.

The Fund's education benefits are much more liberal than those of most other State agencies, allowing full payment, in advance, of all costs for pursuing academic degrees. For example, the Fund paid nearly $11,000 between January 1987 and February 1988 for one employee's education.

The Board May Not Adequately Represent Policyholders

The composition of the State Fund Board of Directors limits its effectiveness in representing policyholders. Although the law requires that members be policyholders when appointed, weaknesses in the appointment process have placed nonpolicyholders on the Board. Of the 12 persons serving on the Board since it was established in 1969, three were not policyholders when appointed and three others purchased limited policies just prior to appointment. Thus, half of the Fund's directors did not have the prior experience with the Fund, as implied by law. In addition, the three-member Board may be too small to function effectively. Its size makes compliance with Arizona's Open Meeting Law almost impossible, since any conversations or meetings between two members constitute actions involving a quorum of the Board.

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

LINDA J. BLESSING, CPA
DEPUTY AUDITOR GENERAL

December 8, 1988

Members of the Arizona Legislature
The Honorable Rose Mofford, Governor
Mr. William L. Finley, Chairman of the Board
State Compensation Fund

Transmitted herewith is a report of the Auditor General, a Performance Audit of the State Compensation Fund. This report is in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee.

We found that the State Compensation Fund is a State agency subject to control of the Legislature. Because the Fund is a State agency, the Legislature may arguably have access to some or all of the Fund's excess surplus. Further, as a State agency, the Fund has benefited from certain advantages and subsidies not available to other workers' compensation insurers. For example, the Fund was not required to pay $2 million in 1987 Federal income taxes which it would have incurred as a private company. We also found that although the Fund operates much like a private insurance company, it has not adopted some important techniques used within the industry to effectively manage claims. Finally, the Fund failed to comply with statutory requirements in purchasing approximately $33 million worth of office buildings.

My staff and I will be pleased to discuss or clarify items in the report.

Sincerely,

Douglas R. Norton

Douglas R. Norton
Auditor General

DRN:WT:lmn

STAFF: William Thomson
Mark Fleming
Cindy G. Whitaker
Dennis B. Murphy
Jayne E. Burgess

Enclosure

2700 NORTH CENTRAL AVE. ● SUITE 700 ● PHOENIX, ARIZONA 85004 ● (602) 255-4385

SUMMARY

The Office of the Auditor General has conducted a performance audit of the State Compensation Fund in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset review set forth in Arizona Revised Statutes (A.R.S.) §§ 41-2351 through 41-2379.

All employers with one or more employees must provide workers' compensation insurance for their employees. The State Compensation Fund is the major provider of workers' compensation insurance in Arizona. Fund policyholders account for approximately 60 percent of all workers' compensation policies in the State. The Fund was established as part of the Industrial Commission in 1925 and became a separate agency in 1969. For calendar year 1988 the Fund has 689 authorized positions and an operating budget of approximately $34.3 million. The Fund's 1987 financial statements reported assets of more than $659 million.

The Fund Is A State Agency Subject To Legislative Control **(see pages 15-23)**

Arizona law clearly establishes the Compensation Fund as a State agency and the State is liable for losses sustained by the Fund. The Fund's status as a State agency gives the Legislature broad authority over the Fund, including the right of termination under the Arizona Sunset Law.

Because the Fund is a State agency, the Legislature may arguably have some control over the Fund's assets. For example, terminating the Fund might allow the Legislature to distribute the Fund's assets. Once all outstanding claims against the Fund were resolved the Legislature could argue that any remaining funds belong to the State because the Fund is a State agency whose liabilities are backed by the State. However, the Legislature's authority beyond this point is uncertain. No law authorizes the sale of the Fund. However, recent court decisions in New York and Oregon might support a Legislative attempt to appropriate some of the Fund's surplus without terminating the agency, but Arizona case law is unclear on this matter.

If the Legislature wishes to consider terminating the State Compensation Fund and/or transferring some of the Fund's surplus to the General Fund, it should obtain further legal research on the potential consequences of such action.

The Legislature Should Evaluate The State's Relationship With The State Compensation Fund **(see pages 25-37)**

The need for the Compensation Fund and its role in providing workers' compensation insurance has changed since the Fund was established in 1925. The Fund was initially intended to insure all employers, and in particular those employers unable to obtain insurance elsewhere. However, the Fund is no longer required to insure employers, and is now one of more than 100 companies in Arizona competing in the workers' compensation market.

Although the Fund no longer serves as an insurer of last resort, it continues to benefit from its past and present relationship with the State. The Fund accumulated substantial reserves between 1926 and 1968 when the Industrial Commission allowed it to charge rates 10 percent below other insurers. These reserves provided sufficient investment income to allow the Fund to sell policies at lower costs and offer yearly dividends after it became a separate agency in 1969. As a result, the Fund has maintained a sizable market share and the reserves needed to adequately fund this share continue to enable the Fund to offer lower prices and dividends. Thus, the Fund continues to enjoy a competitive advantage over private insurers. In addition to this advantage, the Fund saves approximately $2.4 million annually because it pays no Federal income tax and is not required to establish the security deposit required of other insurers. The Fund saves another $1.4 million each year by purchasing goods on State contracts and participating in the State personnel system, risk management and cash management programs.

The Legislature should consider reducing the Fund's competitive advantage by requiring it to: 1) pay the equivalent of its Federal income tax liability to the General Fund, and 2) reimburse the State for the full cost of all services paid for by General Fund appropriations. The Legislature should also review the need for the Fund and determine whether the State should compete with private insurers.

Claims Management Could Be Improved Through Private Sector Procedures (see pages 39-51)

The Fund does not employ procedures commonly used by private insurers to manage claims. Unlike most private companies contacted by Auditor General staff, the Fund does not assign cases so that more experienced staff handle more difficult, complex cases. Procedures for managing claims are also weak compared with private insurers. Supervisory review of claims is limited, investigations are often not thorough or timely, and the Fund does not use enough medical personnel to manage medical aspects of claims.

Failure to manage claims can result in unnecessary costs and, consequently, higher premiums for policyholders. For example, a claims representative did not investigate discrepancies in claims information or follow up on medical reports that indicated a claim was not valid. As a result, the Fund paid almost $90,000 for unnecessary treatment. In another case, the Fund authorized questionable surgery that resulted in $99,000 of unnecessary medical and compensation costs.

Access Control And Disaster Recovery Procedures For State Fund Data Processing Are Weak (see pages 53-58)

Although the State Fund relies heavily on its electronic data processing (EDP) system for many operations, controls are weak in two critical areas. The Fund has not established effective controls such as passwords, operations logs and physical restrictions to protect EDP operations and programs from unauthorized access. Lack of control increases the risk of fraud and abuse. In addition, the Fund has not developed adequate plans to ensure continued operations in the event of a disaster. The Fund has an informal agreement with another organization to use its computer but has not determined how much time would be available, frequency or duration of use.

Some Actions Have Not Been Fiscally Responsible (see pages 59-66)

The Fund has demonstrated questionable fiscal responsibility in some areas. Recent building acquisitions did not comply with statutory

requirements because the Fund did not submit capital outlay plans to the Joint Legislative Budget Committee or obtain appropriate authorization from its Investment Committee. In addition, some expenses from the Fund's annual training programs seem extravagant. The Fund spent more than $113,000 in 1987 and 1988 for two training institutes. Expenditures included meals, lodging and arrival gifts for out-of-state guests; lodging for employees not on travel status; and gifts of watches, luggage and leather attache cases for some employees. Some of these expenses, especially the gifts, may violate constitutional and statutory restrictions on use of public monies.

The Fund's education benefits are much more liberal than those of most other State agencies, allowing full payment, in advance, of all costs for pursuing academic degrees. For example, the Fund paid nearly $11,000 between January 1987 and February 1988 for one employee's education.

The Board May Not Adequately Represent Policyholders **(see pages 67-71)**

The composition of the State Fund Board of Directors limits its effectiveness in representing policyholders. Although the law requires that members be policyholders when appointed, weaknesses in the appointment process have placed nonpolicyholders on the Board. Of the 12 persons serving on the Board since it was established in 1969, three were not policyholders when appointed and three others purchased limited policies just prior to appointment. Thus, half of the Fund's directors did not have the prior experience with the Fund, as implied by law. In addition, the three-member Board may be too small to function effectively. Its size makes compliance with Arizona's Open Meeting Law almost impossible, since any conversations or meetings between two members constitute actions involving a quorum of the Board.

TABLE OF CONTENTS

	Page
INTRODUCTION AND BACKGROUND	1
SUNSET FACTORS	9
FINDING I: THE STATE COMPENSATION FUND IS A STATE AGENCY SUBJECT TO CONTROL BY THE LEGISLATURE	15
Fund Operates Under Statutory Authority	15
Legislature Has Broad Authority Over The Fund	18
Recommendation	23
FINDING II: THE LEGISLATURE SHOULD EVALUATE ARIZONA'S RELATIONSHIP WITH THE STATE COMPENSATION FUND	25
Need For Fund And Its Role In Providing Workers' Compensation Insurance Has Changed Significantly	25
Fund Continues To Benefit From Relationship With State	28
Legislature Should Consider Altering The State's Relationship With The Fund	35
Recommendations	36
FINDING III: THE STATE COMPENSATION FUND CAN SIGNIFICANTLY IMPROVE ITS CLAIMS MANAGEMENT BY ADOPTING PROCEDURES USED BY THE PRIVATE SECTOR	39
Claims Are Not Assigned In An Effective Manner	39
More Supervisory Review, Better Investigations And Stronger Medical Management Procedures Are Needed	41
Effective Claims Management Can Reduce Costs	48
Recommendations	51

Page

FINDING IV: SIGNIFICANT WEAKNESSES EXIST IN ACCESS CONTROL AND DISASTER RECOVERY PROCEDURES OF THE FUND'S COMPUTER SYSTEMS, INCREASING THE RISK OF FRAUD OR ABUSE. 53

Access Controls And Physical Security Are Weak. 54

Disaster Recovery Controls Are Inadequate 56

Recommendations 57

FINDING V: THE FUND HAS NOT BEEN FISCALLY RESPONSIBLE IN SOME AREAS 59

The Fund Has Not Complied With Statutory Requirements During Building Purchases 59

Employee Awards And Training And Education Benefits Appear Excessive And May Be Illegal 62

Recommendations 66

FINDING VI: THE BOARD OF DIRECTORS MAY NOT EFFECTIVELY REPRESENT POLICYHOLDERS 67

The Board Of Directors Has A Duty To Represent Policyholders 67

Appointment Process Has Been Weak 68

The Board Is Too Small. 69

Recommendations 71

OTHER PERTINENT INFORMATION 73

AREAS FOR FURTHER AUDIT WORK 75

AGENCY RESPONSE . . . . . .

APPENDIX

I. LEGISLATIVE COUNCIL OPINION

LIST OF TABLES

		Page
TABLE 1 -	State Compensation Fund Expenditures For Calendar Years 1986 Through 1988 (Unaudited)	3
TABLE 2 -	State Compensation Fund Statement Of Operations And Changes In Policyholders' Surplus, 1986 And 1987	5
TABLE 3 -	State Compensation Fund Balance Sheet, 1986 And 1987	6
TABLE 4 -	Small Policyholder Representation In State Compensation Fund, Policy Years 1983 Through 1985	29
TABLE 5 -	State Compensation Fund Operational Analysis Of Net Increase in Surplus, 1987 And 1986	31
TABLE 6 -	Estimated Savings To The Fund Due To State Subsidies	34
TABLE 7 -	Supervisory Review Guidelines For Selected Private Workers' Compensation Insurance Carriers	43
TABLE 8 -	State Compensation Fund Institute Expenses - 1987 And 1988	63
TABLE 9 -	Number Of Policyholders And Board Members Of Competitive State Funds	70

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the State Compensation Fund in response to a June 2, 1987, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

Arizona law requires that all employers with one or more employees provide workers' compensation coverage. Employers may insure this liability either through the State Compensation Fund, through a private insurance carrier, or through self-insurance. Workers' compensation insurance pays all medical costs resulting from work related injuries, and compensation for lost wages.

The State Compensation Fund was established in 1925 as part of the Industrial Commission. The Industrial Commission administered the Fund until 1969 when legislation established the Fund as an independent agency. In 1983 additional legislation exempted the Fund from some management and review requirements applicable to State agencies, such as budgetary and fiscal reviews, surplus property and purchasing requirements. In addition, the Fund became subject to State insurance statutes.

The Fund has grown significantly in recent years, and is currently the largest writer of workers' compensation insurance in Arizona. According to Fund budget information, the number of Fund policyholders has increased from 31,034 in 1985 to an estimated 42,000 in 1988. In the same period, premiums will nearly double from $104.4 million to approximately $190 million. The number of claims processed by the Fund is expected to increase approximately 27 percent, from 54,524 in 1985 to an estimated 69,000 in 1988.

Organization And Staffing

The Fund is under the direct supervision of a three-member Board of Directors appointed by the Governor for three-year terms. Members are required to be Fund policyholders or employees of policyholders. The Board has authority to make rules and regulations as it deems proper, and appoints the Fund Manager, responsible for the organization's daily operations. The Board may also declare dividends for its policyholders. In 1987 it declared dividends of approximately $30 million.

The Fund's Investment Committee is statutorily responsible for establishing the investment policy and supervising the Fund's investment activities. This five-member Committee consists of the Chair of the Board of Directors, the Fund Manager, and three persons appointed by the Governor who are knowledgeable in investments and economics. In 1987 the Fund invested more than $591 million.

The Fund has 689 authorized full-time (FTE) positions for 1988. The Fund operates from an office located in the Abacus building in central Phoenix. The home office has 534 FTEs. Fund staff also work out of district offices in Flagstaff, Tucson, Mesa, Glendale, Phoenix, Show Low, Lake Havasu City, Prescott and Yuma. District operations account for 155 FTEs.

Budget And Financial Position

The State Compensation Fund is funded by premium and investment income, receiving no General Fund appropriations. It operates on a calendar year basis, and annually must submit an operating and capital outlay budget to the Joint Legislative Budget Committee (JLBC) for review and approval. The JLBC approved $34 million for Fund operations in 1988. Table 1 shows Fund expenditures excluding compensation and medical benefits for calendar years 1986 and 1987 and the approved budget for 1988. No capital outlay requests were made during this period.

TABLE 1

STATE COMPENSATION FUND
EXPENDITURES FOR
CALENDAR YEARS 1986 THROUGH 1988[a]
(unaudited)

	1986 Actual	1987 Actual	1988 Approved
FTE positions	630	667	689
Personal services	$ 12,594,200	$ 14,010,000	$ 15,572,400
Employee related expenses	2,624,800	2,919,600	3,363,600
Professional & outside services	3,006,500	2,434,600	1,180,500
Travel - State	199,200	189,900	235,900
Travel - out-of-State	50,800	64,400	67,600
Other operating expenses	2,825,700	3,461,100	2,906,600
Equipment	1,939,700	1,063,400	1,340,700
Claims adjustment services	666,000	934,900	701,500
National Council fees	301,850	152,000	348,000
Premium tax to ICA	6,090,600	6,892,000	7,400,000
Uncollectible premiums	962,050	953,400	500,000
Real/personal property tax	113,150	497,700	77,000
License and fees	17,350	34,100	19,300
Building occupancy costs			411,800
Computer software expenses			213,700
Other	13,100	900	
TOTAL	$ 31,405,000	$ 33,608,000	$ 34,338,600

(a) Expenditure amounts are rounded.

Source: Joint Legislative Budget Committee staff.

In addition, the Fund is required by statute to have an audit of its accounts, funds and securities by an independent firm of certified public accountants. Financial statements for the years ended December 31, 1986 and 1987 were audited by public accounting firms whose reports expressed unqualified opinions on the statements. Table 2 (page 5) presents the 1986 and 1987 statement of operations and statements of changes in policyholders' surplus. In 1987, the Fund's revenues increased 10 percent while its expenses increased 22 percent over prior years. Table 3 (page 6) presents the Fund's balance sheets for 1986 and 1987.

Audit Scope and Purpose

This performance audit was conducted to evaluate the State Compensation Fund's operations, focusing on these specific objectives.

- To determine the extent of Legislative authority over the Fund.
- To evaluate the role of the State Fund in providing workers' compensation insurance in Arizona and to determine the extent of State support for Fund operations.
- To determine the efficiency and effectiveness of the Fund's claims management and operations.
- To evaluate the adequacy of access controls and disaster recovery procedures of the Fund's computer system.
- To determine if the Fund has acted in a fiscally responsible manner.
- To determine if the State Fund Board of Directors adequately represents policyholders.

This report also contains Other Pertinent Information regarding the Investment Committee, its operations and its relationship to the Board of Directors (see page 73).

TABLE 2

STATE COMPENSATION FUND
STATEMENTS OF OPERATIONS AND
STATEMENTS OF CHANGES IN POLICYHOLDERS' SURPLUS,
1986 AND 1987[a]

	Year ended December 31,	
	1986	1987
Statement of Operations	(in thousands)	(in thousands)
Revenues		
Premiums earned	$149,962	$171,834
Investment income:		
Interest	52,920	58,428
Allocation to self-raters	(2,751)	(2,076)
Net gain on sale of investments	10,678	447
	60,847	56,799
Other income	2,037	4,442
	212,846	233,075
Benefits and other expenses		
Compensation and medical benefits	153,496	162,194
Premium taxes	6,091	6,892
Administrative expenses	24,047	28,247
	183,634	197,333
Net gain	$ 29,212	$ 35,742
Statement of changes in policyholders' surplus		
Balance, beginning of year	$ 63,838	$ 73,050
Net gain	29,212	35,742
Provision for policyholders' dividends	(20,000)	(30,000)
Balance, end of year	$ 73,050	$ 78,792

(a) Financial statement notes accompany the information presented in this table. See State Compensation Fund 1987 Annual Report, Financial Statements, for these notes.

Source: Arizona State Compensation Fund 1987 Annual Report.

TABLE 3

STATE COMPENSATION FUND
BALANCE SHEET
1986 AND 1987[a]

	December 31,	
	1986 (in thousands)	1987 (in thousands)
Assets		
Investment securities:		
Bonds and certificates	$418,197	$514,330
Mortgages	66,696	57,055
	484,893	571,385
Short-term investments	11,471	9,399
	496,364	580,784
Cash	292	103
Premiums receivable, net of allowance for uncollectible premiums of $600,000 in 1986 and $700,000 in 1987	28,375	27,918
Accrued interest receivable	8,921	10,914
Land, buildings and equipment, net	35,301	39,780
	$569,253	$659,499
Liabilities and policyholders' surplus		
Liability for incurred but unpaid losses	$444,935	$512,661
Policyholders' dividends	20,244	33,166
Policyholders' advance premiums	19,914	24,179
Accounts payable and other accrued liabilities	11,110	10,701
	496,203	580,707
Policyholders' surplus	73,050	78,792
	$569,253	$659,499

(a) Financial statement notes accompany the information presented in this table. See State Compensation Fund 1987 Annual Report, Financial Statements, for these notes.

Source: Arizona State Compensation Fund 1987 Annual Report.

The section Areas For Further Audit Work (page 75) addresses issues we identified during the course of our audit but were unable to research due to time constraints.

This audit was conducted in accordance with generally accepted government auditing standards.

The Auditor General and staff express appreciation to the Board of Directors, Investment Committee, Fund Manager and staff of the State Compensation Fund for their cooperation and assistance during the course of our audit.

SUNSET FACTORS

In accordance with Arizona Revised Statutes §41-2354, the Legislature should consider the following 12 factors in determining whether the State Compensation Fund (the Fund), the Board of Directors, the Investment Committee and the Fund Manager should be continued or terminated.

1. **Objective and purpose in establishing the Fund**

   In 1925 the Legislature established the State Compensation Fund within the Industrial Commission to provide workers' compensation insurance. In addition, the Fund was required to insure Arizona employers who could not obtain workers' compensation insurance coverage from private carriers or generate the financial ability to self-insure.

   The role of the Fund changed in 1968 when the Legislature removed the Fund from the Industrial Commission and set it up as a separate State agency. Legislation passed at this time also eliminated the requirement that the Fund serve as the insurer of last resort and created an assigned risk plan (see Finding II, page 25). Although the Fund remains a State agency, it competes with private carriers in the workers' compensation insurance market and is the major provider of worker's compensation insurance in Arizona.

2. **The effectiveness with which the Fund has met its objective and purpose and the efficiency with which the Fund has operated**

   The Fund has been generally effective in providing significant benefits to Arizona employers through lower premiums and dividends than might be offered by private carriers. In addition, the Fund appears to insure the majority of Arizona employers engaged in hazardous industries such as underground and surface mining, logging and aircraft operations.

Although the Fund appears to have been effective in meeting its objective, we identified ways in which the Fund could improve the efficiency and effectiveness of its operations.

- The Fund could significantly improve its claims administration and potentially reduce claims costs through more appropriate case assignments, improved supervisory review of claims, ensuring a minimum level of investigation for claims, and strengthening medical management of claims (see Finding III, page 39).

- The Fund could eliminate significant weaknesses in its electronic data processing system, including computer access controls and physical security which expose the Fund to potential fraud and abuse. Additionally, the Fund could improve its EDP disaster recovery control procedures (see Finding IV, page 53).

The Board of Directors could more effectively represent policyholders if members were required to be Fund policyholders for at least one year prior to their appointment, and if the size and makeup of the Board were enhanced (see Finding VI, page 67).

3. **The extent to which the Fund has operated within the public interest**

The Fund is generally operating in the public interest by meeting its objective and purpose. It provides direct benefits to those employers who choose to insure with the Fund. However, the Fund did not act in the public interest when it violated statutes regarding acquisition of real property, used training funds to purchase gifts and awards for employees and others, and established education benefits well beyond those of most State agencies (see Finding V, page 59).

4. **The extent to which rules and regulations promulgated by the Fund are consistent with the Legislative mandate**

Although the Board of Directors and the Fund Manager have statutory authority to promulgate rules and regulations, neither has chosen to do so.

5. **The extent to which the Fund has encouraged input from the public before promulgating rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public**

Since neither the Board of Directors nor the Fund Manager have chosen to promulgate rules and regulations, input from the public has not been necessary. The Board of Directors and the Investment Committee post public notifications of their meetings in accordance with the Open Meeting Law to inform the public of their meetings. However, due to the small size of the Board of Directors, two Board members constitute a quorum and, therefore, even conversations between members could violate the Open Meeting Law if adequate notification is not made (see Finding VI, page 67).

6. **The extent to which the Fund has been able to investigate and resolve complaints that are within its jurisdiction**

This factor does not apply since the Fund is not a regulatory agency.

7. **The extent to which the Attorney General or any other applicable agency of State government has the authority to prosecute actions under enabling legislation**

This factor does not apply since the Fund is not a regulatory or enforcement agency.

8. **The extent to which the Fund has addressed deficiencies in its enabling statutes which prevent it from fulfilling its statutory mandates**

According to Fund officials, in 1986 the Fund drafted and supported legislation which extended the benefits of the Workers' Compensation Law to individual owners of business (sole proprietors) if these individuals desired such coverage. Prior to this, the Fund proposed legislation, enacted in 1983, which eliminated General Fund support for some Fund services, including telecommunications, motor pool, finance, and library and archives.

9. **The extent to which changes are necessary in the laws of the Fund to adequately comply with the factors listed in the Sunset Law**

Based on our audit work we recommend that the Legislature consider the following changes to the statutes of the Fund and its Board of Directors.

- Amend A.R.S. §23-987 to require the Fund to pay an amount to the State General Fund equivalent to the Federal income tax it would owe as a private company (see Finding II, page 25).

- Amend A.R.S. §23-981.01 to require that persons appointed to the Board of Directors be insured by the Fund for a minimum of one year prior to their appointment (see Finding VI, page 67).

- Amend A.R.S. §23-981.01 to increase the size of the Board of Directors to at least five members and provide for expanded policyholder representation of specified occupations and interests on the Board (see Finding VI, page 67).

10. **The extent to which the termination of the Fund would significantly harm the public health, safety or welfare**

Termination of the Fund would not significantly harm public welfare. More than 100 private insurance carriers are certified to provide workers' compensation insurance to Arizona employers. In addition, there is an assigned risk plan for those employers who are unable to obtain insurance from private carriers. However, terminating the Fund could cause disruptions in the supply of workers' compensation insurance, and may be particularly difficult for the employers engaged in hazardous industries who tend to insure with the Fund (see Finding II, page 25).

11. **The extent to which the level of regulation exercised by the Fund is appropriate and whether less or more stringent levels of regulation would be appropriate**

This factor does not apply since the Fund is not a regulatory agency.

12. **The extent to which the Fund has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished**

The Fund utilizes the services of a variety of private contractors in performing its duties. Major services used by the Fund include computer assistance, outside temporary help, legal assistance, rehabilitation counseling, and hospital cost reviews. During 1987, the Fund spent over $2 million for these services.

In addition, the Board of Directors contracts with an outside auditing firm to conduct an annual audit of the Fund, at a cost of $37,000 for 1987. The Board also utilizes the services of an outside actuarial firm to establish the reserves needed by the Fund to cover losses which have already occurred but have not yet been paid. The Board paid $67,500 for actuarial services in 1987.

The Investment Committee, as mandated by statute, uses the services of an investment counsel to advise in investing Fund monies, at a cost of approximately $112,000 in 1987.

FINDING I

THE STATE COMPENSATION FUND IS A STATE AGENCY, SUBJECT TO CONTROL BY THE LEGISLATURE

The Arizona Legislature can exercise significant control over the State Compensation Fund. The Fund is a State agency, established and operating under statutory authority granted by the Legislature. As such, the Legislature has broad control over the Fund.

Fund Operates Under Statutory Authority

The Fund was established and is authorized to operate by statute. An analysis of Arizona statutes shows that the Fund is a State agency.[1] This analysis does not support contentions that the Fund is a mutual insurance company controlled by the policyholders.

Fund is a State agency - The statutory authorization of the Fund identifies it as a State agency established to insure employers against liability for workers' compensation and medical benefits. As a State agency, the assets of the Fund are public funds. In addition, Arizona law makes the State liable for the losses sustained by the Fund.

Arizona laws indicate that the Fund is a State agency. Numerous statutory provisions support this position.

- A.R.S. §23-981.A. The Fund is established by the Legislature for the purpose of insuring employers against liability for workers' compensation and medical benefits.

---

(1) This finding is generally based on a legal analysis from the Attorney General's Office. We requested advice on the Legislature's authority to terminate the Fund under the Arizona Sunset Law, and on the statutory and case law applicable to the exercise of legislative authority. Informal advice was requested because a formal opinion could not be obtained within audit time constraints.

- A.R.S. §23-981.E — The annual operating and capital outlay budget of the Fund is approved by the Joint Legislative Budget Committee.
- A.R.S. §23-981.01.A — The Fund is under the supervision of a Board of Directors appointed by the Governor.
- A.R.S. §23-982.A & B — The State Treasurer is the custodian of the Fund. All monies collected by the Fund and all disbursements made by the Fund, except for authorized investments, must go through the State Treasurer.
- A.R.S. §23-982.C — An annual financial audit of the Fund is filed with the Secretary of State and the Insurance Department, and is open to public inspection.
- A.R.S. §23-983.A — The Fund shall be neither more nor less than self-supporting.
- A.R.S. §23-985 — Majority of members of an Investment Committee, established to set investment policy and supervise the investment activities of the Fund, are appointed by the Governor.
- A.R.S. §23-986.A & D — The insurance regulatory provisions of Title 20 apply to the Fund to the same extent as any mutual casualty insurer authorized to write workers' compensation insurance. However, in the event recommendations made by the Director of Insurance as a result of an examination of the Fund are not complied with, the Director of Insurance shall notify the Governor, President of the Senate and Speaker of the House.

Because the Fund is a State agency, the assets of the Fund are public funds in the hands of public officials. This position is supported by the fact that all monies collected and disbursed by the Fund, except those for authorized investments under A.R.S. §24-945, must go through the State Treasurer. Fund officials are public officials because the Board of Directors is appointed by the Governor. The Board in turn appoints the Fund Manager who is empowered to oversee the daily operations of the Fund.

The Fund's status as a State agency is further supported by the State's liability for the losses sustained by the Fund. A.R.S. §23-981.C reads, in part:

> "A Manager shall administer the state compensation fund, subject to the authority of the Board of directors, without liability of the state beyond payment of losses sustained on account of the fund." (emphasis added)

This statutory provision makes the State liable for losses sustained by the Fund beyond the amount of reserves[1] and surplus[2] held by the Fund. In addition, provisions establishing procedures to be followed if the Fund becomes unable to meet its liabilities also support the position that the State is liable for claims against the Fund. When private companies face insolvency, the Director of the Department of Insurance can order the company to cease operations. However, if the Fund is in danger of becoming insolvent, A.R.S. §23-986.D requires the Insurance Department Director to make recommendations to the Fund and notify the Governor, Speaker of the House and President of the Senate if the Fund fails to comply with the recommendations.

Fund is not a mutual insurance company - Although Fund officials describe it as a mutual insurance company, it is a State agency and not a mutual insurance organization. Therefore, the policyholders are not liable for losses sustained by the Fund, nor are they entitled to dividends.

Although the provisions of Title 20 which regulate companies offering insurance in Arizona apply to the Fund, the Fund's authorizing statutes

---

(1) Reserves are those assets set aside to make future payments on losses that have already occurred.

(2) When discussing a State agency operating as an enterprise fund, such as the State Compensation Fund, fund balance is the appropriate term for those assets which exceed liabilities. However, the Fund is governed by Arizona insurance laws and regulations which generally use the term surplus to refer to assets in excess of liabilities. This usage is common within the insurance industry. Therefore, to ensure consistency with Arizona law and industry practice, we have used the term surplus to describe those assets which exceed liabilities.

do not establish the Fund as a mutual insurance company. A mutual insurance company is generally defined as an entity which is organized and operated for the benefit of its policyholders, who are by virtue of their policies members of the company. Members usually elect the Board of Directors and are liable for losses should the company become insolvent. The payment of dividends may be mandated by statute or be discretionary with the Board. If the Board has discretion, the right to receive a dividend creates no trust or property interest of the policyholder in the surplus.[1]

Based on this definition, the Fund does not appear to be a mutual insurance company because: 1) the Fund was created by the Legislature and exists as a State agency, 2) the State, not the policyholders, is liable for the payment of losses sustained by the Fund, 3) the Board members are appointed by the Governor rather then elected by the policyholders and 4) Fund policyholders are not entitled to dividends.[2]

Legislature Has Broad Authority Over The Fund

Since the Fund is a State agency, the Legislature has broad authority over the Fund. The Legislature has the authority to terminate the Fund under the Arizona Sunset Law, but there is no statutory authority for selling the Fund. However, courts in two states have upheld legislative use of a state compensation fund's surplus monies for other public purposes.

Authority to terminate Fund - The Legislature may terminate the Fund. The Legislature has statutory authority to control the distribution of assets upon dissolution of the Fund, and may be able to obtain any remaining assets.

---

(1) See Methodist Hospital of Brooklyn v. State Insurance Fund, 64 N.Y. 2d 365, 486 N.Y.S. 2d 905,909-910,476 N.E. 2d 304 (Ct. App. 1985).

(2) A.R.S. §23-981.01.A. grants the Board discretion in declaring dividends to policyholders but does not require the Board to pay dividends.

The Legislature's authority over the Fund includes the right to terminate the Fund under the sunset provisions and repeal the statutory provisions establishing the Fund. Under A.R.S. §41-2366.A.9, the State Compensation Fund Board of Directors, the Fund Manager and the Investment Committee are scheduled to be terminated on July 1, 1990. Furthermore, A.R.S. §41-2377.F provides that the Sunset provisions do not prohibit the Legislature from terminating an agency at an earlier date, or from considering any other legislation relative to the agency. Thus, the Legislature has the authority to Sunset the Fund's administrative functions or repeal the statutory provisions relating to the Fund.

The Legislature arguably may control the distribution of assets if it terminates the Fund. A.R.S. §23-1029.B stipulates that all money in the Fund is subject to the disposition of the Legislature if the Fund's enabling legislation is repealed. This statute provides one basis for the argument that repeal of the Fund's enabling statutes would subject its assets to disposition by the Legislature. If the Fund were dissolved and all outstanding claims against the Fund were properly resolved, the remaining surplus may arguably belong to the State because the Fund is a State agency whose liabilities are backed by the State.

Arizona statutes and case law provide little support for the argument that the assets would belong to the policyholders upon termination of the Fund because: 1) the Fund is a State agency, not a mutual insurance company, and 2) the insurance contracts with the Fund do not give policyholders any property interest in the Fund.

It would be difficult to estimate what assets would remain after all outstanding claims against the Fund were properly resolved. However, the loss reserves established by the Fund, and required by statute, for incurred but unpaid losses are actuarially determined to be sufficient to cover such claims. Therefore, at least a portion, if not all, of the approximately $78 million in surplus currently maintained by the Fund may remain after dissolution of the Fund and proper resolution of all claims and liabilities.

Sale of Fund - The Legislature's authority over the Fund would probably not include the sale of the Fund to a third party. Although legislation has been introduced during recent legislative sessions to sell the Fund, such legislation may not provide adequate authority for the sale of the Fund as an ongoing entity. A preliminary review found no precedent in case law in which a state attempted to sell a state insurance fund as an ongoing state agency. Furthermore, Arizona case law characterizing the Fund as a private trust fund could mitigate arguments that the Legislature has authority to sell the Fund.

Use of surplus funds - The Legislature may have access to the surplus maintained by the Fund without terminating it. The State's liability for losses sustained by the Fund provides support for the argument that the Legislature may obtain all or a portion of the Fund's surplus. In other states, the legislative transfer of insurance fund surplus also presents an argument that Fund surplus monies may be available to Arizona. The New York and Oregon legislatures have transferred surplus monies from their state insurance funds into their respective general funds.

In 1987, the State Compensation Fund had approximately $21.5 million of excess surplus. According to the Director of the Department of Insurance, A.R.S. §20-210 requires the Fund to maintain a $750,000 surplus. Additionally, a departmental guideline used to measure financial solvency suggests that a carrier maintain a minimum of $1 of surplus monies for each $3 of premium earned, or a ratio of 1 to 3.[1] Auditor General analysis of the Fund's 1987 balance sheet found that the Fund retained approximately $78.8 million in surplus while reporting earned premiums of $171.8 million, a ratio of 1 to 2.18. As such, for the year ending December 31, 1987, the Fund's reported

---

(1) According to DOI officials, the surplus to premium ratio of 1 to 3 is a standard used by regulators to evaluate the solvency of all carriers. When a carrier exceeds this ratio, it sends a signal to regulators that an evaluation of the carrier's practices may be in order. Additionally, as a part of the Fund's annual request to DOI for approval of a substantial deviation (discount) from filed rates, DOI officials have raised questions about the Fund's surplus to premium ratio. However, DOI officials stressed that their concern is whether the Fund can support such a large deviation from established rates and not whether the Fund maintains sufficient surplus to remain solvent.

surplus exceeded Department of Insurance guidelines by approximately $21.5 million.[1]

The New York legislature transferred $190 million from surpluses of its State Insurance Fund (the equivalent of the Arizona State Compensation Fund) to its general fund. In exchange, the Legislature provided an annual $190 million "dry appropriation" to be included as an asset of the Fund, which would not actually be paid unless the Fund's reserves become depleted. Legal challenges to the transfer in New York were defeated based on a decision by the court that: 1) the insurance fund was a state agency and not a mutual insurance company controlled by the policyholders, 2) the insurance fund's proceeds were held as state monies against which the policyholders had no property rights, and 3) the insurance fund's liabilities were those of the state and not those of the policyholders. Similar arguments could be made in relation to the Arizona Fund.

The Oregon Legislature transferred $81 million of surplus proceeds from its Compensation fund, the State Accident Insurance Fund (SAIF), to its general fund. The legislature also imposed a 44.5 percent franchise tax on the fund's surplus proceeds, to be effective only if the statutes transferring surplus proceeds are declared invalid by the

---

(1) The $21.5 million represents a conservative estimate of the excess surplus maintained by the Fund. By statute, the Fund need only maintain $750,000 in surplus. Furthermore, the State is liable for losses sustained by the Fund, and the Department of Insurance is required to notify the Governor, the President of the Senate and the Speaker of the House in the event the Fund is in danger of becoming insolvent. As such, any action taken against the Fund in the event it did not meet the Department of Insurance guideline for premium to surplus ratio would be left to the Governor and the Legislature. In addition, due to the low discount rates used by the Fund in calculating its loss reserves (see Areas For Further Audit Work, page 75), it may be possible to transfer additional loss reserves to surplus.

courts. A lawsuit challenging the transfer of surplus in Oregon is presently pending before its State Supreme Court. The Oregon Attorney General is arguing against the appeal on the basis that the Oregon SAIF is an instrumentality of the State which by law can not be owned by the insured employers. Rather, the insured employers have a contract with the SAIF which provides workers' compensation insurance coverage for a specified time period. The Oregon Attorney General concludes that since the employer/policyholder is not contractually or statutorily entitled to a dividend, the transfer of surplus did not violate any property rights.[1]

Arizona case law is not clear on the transfer of Compensation Fund monies. The Arizona Supreme Court in Sims v. Moeur (1933) and Industrial Commission v. School District No. 48 (1941) held that the Fund is a trust fund undertaken by the State to be administered for the use and benefit of employees and employers/policyholders.[2] However, the Court has also recognized that: 1) the Legislature established the Fund and can also terminate it, 2) the Fund is public monies in the hands of public officials who administer it, 3) the Fund should be self-supporting and no more, and 4) the Fund does not belong to those who administer it, the insured employees or the employer/policyholders. These cases are nearly 50 years old, and were decided while the Fund was administered by the Industrial Commission before it became a separate State agency. However, courts have not considered the proper disposition of State Fund monies upon its termination or the use of surplus monies for non-Fund purposes.

---

(1) Legislative attempts to transfer surplus monies from the state insurance fund in two other states, Oklahoma and Utah, were unsuccessful. Unlike New York and Oregon, the states of Oklahoma and Utah have no liability for losses sustained by their respective state funds, an important factor raised in court decisions.

(2) A 1979 Attorney General Opinion (Arizona Attorney General Opinion No. 179-091 (R78-340)) also held that premiums paid to the Fund are not State tax revenue under the definition set forth in the former subsection E, deleted in 1980, of A.R.S. §41-562. However, this opinion addressed a much narrower question - whether premiums were tax revenues. The opinion did not address the larger legal issues addressed in our informal opinion, namely the Legislature's authority over the Fund and its monies.

RECOMMENDATION

The Legislature should consider obtaining further legal research on the potential issues involved in terminating the State Fund. Further research should address questions regarding the disposition of Fund assets upon termination, the Legislature's authority to transfer Fund assets to the General Fund and legislative authority to sell the State Fund.

FINDING II

THE LEGISLATURE SHOULD EVALUATE ARIZONA'S RELATIONSHIP WITH THE STATE COMPENSATION FUND

The Legislature should evaluate the State of Arizona's relationship with the State Compensation Fund (the Fund). The need for the Fund and its role in providing workers' compensation insurance to Arizona employers has changed significantly since the inception of the Fund. Although the nature of the Fund has changed, it continues to benefit from its relationship with the State. Based on the effect of these changes, the Legislature should consider altering the State's relationship with the Fund.

Need For Fund And Its Role In Providing Workers' Compensation Insurance Has Changed Significantly

The need for the Fund and its role in providing workers' compensation insurance has changed significantly since the inception of the Fund. The Fund was initially established to act as a source of last resort for workers' compensation insurance. However, due to changes over time, the Fund is now Arizona's major workers' compensation carrier. This evolution of the Fund indicates that the need for the Fund has changed.

Source of last resort - The Fund was initially established to serve as a source of last resort for employers unable to obtain workers' compensation insurance. However, while under the administration of the Industrial Commission of Arizona (ICA), the Fund held a virtual monopoly on workers' compensation insurance. This monopoly ended when the Legislature established the Fund as a separate State agency.

The Fund was initially established to insure Arizona employers who could not obtain workers' compensation insurance elsewhere. In 1925 the Legislature adopted legislation that required employers to obtain

insurance coverage for injuries sustained by their employees. The Legislature gave employers three alternatives to secure such coverage: 1) the State Compensation Fund,[1] 2) private insurance carriers, and 3) self-insurance, provided the employer could furnish proof of financial ability to pay for losses.

According to the 1925 legislation, the Fund was established ". . . for the purpose of insuring employers against liability for compensation under this act . . ." Furthermore, a review of the 1925 legislation indicates that private carriers were not required to provide coverage to employers. Therefore, if an employer could not obtain coverage from a private carrier and did not have the financial ability to self-insure, the Fund was the only remaining alternative.

The 1925 legislation establishing the Fund placed it under the administrative authority of the ICA. The legislation gave the ICA authority to set premium rates for both the Fund and private carriers. A review of the early ICA annual reports reveals that the Fund's share of the workers' compensation insurance market grew from approximately 40 percent in 1927 to more than 97 percent in 1934. According to ICA annual reports and the Fund's former chief counsel, the ICA was able to capture the vast majority of the market by allowing the Fund to offer approximately a 10 percent discount on its premium rates from the rates which the ICA set for private carriers.

The Fund's 40-year monopoly domination of the Arizona workers' compensation insurance market ended when the Fund was established as a separate State agency. In 1968, the Legislature adopted legislation that removed the Fund from the administrative authority of the ICA, thereby creating the Fund as a separate State agency. The legislation

---

(1) The 1925 legislation required the State of Arizona and all political subdivisions to obtain their workers' compensation coverage from the Fund.

also removed the ICA's authority to set insurance rates[1], thereby ending the Fund's monopoly over the Arizona workers' compensation insurance market.

Although the Fund no longer maintains a monopoly over the workers' compensation insurance market, it remains the major workers' compensation insurance carrier in Arizona. In 1986 the Fund had approximately 36,000 policyholders. During the same period, the Fund reported $145.3 million in earned premiums to the ratings organization, approximately 40 percent of all earned premiums for workers' compensation insurance in Arizona. The Fund has averaged approximately 40 percent of the earned premium market since its separation from the ICA in 1969.

- **Need for Fund has changed** - The Fund's evolution over time suggests that the need for the Fund has changed. The Fund no longer acts as the source of last resort to provide workers' compensation insurance. In addition, the Fund does not appear to represent small policyholders beyond what its total market share would dictate.

The Fund no longer acts as the source of last resort for workers' compensation insurance. The 1968 legislation that made the Fund a separate State agency also established an assigned risk plan. Under this plan, any employer who is refused coverage by the Fund and two or more carriers is placed in the assigned risk plan. Assigned risk employers are apportioned among carriers authorized to write workers' compensation insurance within Arizona based on each carriers share of the total premiums written.[2] Because of the assigned risk plan, the Fund is no longer required to extend coverage to all Arizona employers.

Contrary to claims made by the Fund, the Fund does not appear to represent small policyholders beyond what its total market share would dictate. According to data obtained from the rating organization, the

---

(1) Workers' compensation insurance rates are now submitted by a ratings organization, to which workers' compensation carriers must subscribe, to the Department of Insurance for review and approval.

(2) The rating organization used by the State's workers' compensation insurance carriers to submit rate changes to the Department of Insurance administers the assigned risk plan.

National Council on Compensation Insurance (NCCI), for policy years 1983 through 1985,[1] the Fund's share of small policyholders (those with annual earned premium of $5,000[2] or less) closely matched its total market share of policyholders (Table 4, page 29). For example, in 1985 the Fund insured 64 percent of small policyholders, a portion equal to its total market share. However, small policyholders accounted for 80 percent of the market. If the Fund did in fact concentrate on insuring small policyholders, its share of small policyholders would exceed 65 percent. The Fund's share of small policyholders also equaled its total market share in 1983 and 1984.

Fund Continues To Benefit From Relationship With State

Although the Fund has become Arizona's major workers' compensation carrier, it continues to benefit from its past and present relationship with the State. These benefits have resulted in certain advantages which have helped the Fund sustain a dominant market share. These advantages include: 1) a large investment portfolio, derived in part from the Fund's prior monopoly, 2) exemption from Federal income taxes and a significant security deposit required of private workers' compensation insurance carriers, and 3) receipt of goods and services subsidized by the State of Arizona.

---

(1) NCCI collects policyholder data from all workers' compensation insurers in Arizona for rate making purposes, and provides specific guidelines on the submission of this data. As such, NCCI represents the only source for comparative data on workers' compensation policyholders. The years analyzed represent the latest periods for which NCCI had complete data.

(2) We used the $5,000 earned premium level since the vast majority of policyholders in the State had earned premiums of less than $5,000 (earned premiums ranged from less than $250 to more than $500,000). In addition, premium discounts, offered to "larger" policyholders, begin at the $5,000 earned premium level. However, we also analyzed the Fund's market shares at lower earned premium levels ($250, $1,000, and $3,500) and found that the Fund's share did not change appreciably.

TABLE 4

SMALL POLICYHOLDER REPRESENTATION IN STATE COMPENSATION FUND
POLICY YEARS 1983 THROUGH 1985

Policy Year	1983	1984	1985
Total Arizona policyholders	51,002	53,438	53,616
Total SCF policyholders	25,868	28,217	34,295
SCF Percentage of total Arizona policyholders[a]	50.7	52.8	64.0
Total Arizona policyholders with earned premium less than $5,000	43,991	45,090	43,138
Total SCF policyholders with earned premium less than $5,000	22,656	23,977	27,636
SCF percentage of total Arizona policyholders with earned premium less than $5,000[a]	51.5	53.2	64.1

(a) All percentage figures have been rounded.

Source: Auditor General analysis of data obtained from NCCI for policy years (March through February) 1983, 1984 and 1985.

Investment income - Income from investments has allowed the Fund to remain extremely competitive by offering significant premium reductions and dividends to policyholders. The large market share maintained by the Fund, both before and after the 1968 legislation, has required the Fund to establish significant reserves for the future payment of losses which have already occurred. In addition, the Fund maintains a large amount of surplus monies (see Finding I, page 15). These reserves and surplus monies comprise a large investment portfolio from which the Fund earns significant interest income. For example, for calendar year 1987 the Fund reported interest income of $58.4 million[1] on investments that totalled more than $580 million.

In effect, this investment income allows the Fund to offer premium reductions and dividends to policyholders. Since 1982 the Fund has given all of its policyholders a sizeable deviation (discount) from the premium rates that are filed by the ratings organization. This rate deviation has ranged from 17.5 percent in 1982 to 32.5 percent in 1984. The current rate deviation is 25 percent, and represents one of the highest deviations offered by a workers' compensation insurance carrier in Arizona. In addition, the Fund has consistently paid dividends to policyholders each year since 1969.

Offering such discounts has two effects. First, it allows the Fund to be one of the most competitively priced workers' compensation carriers in Arizona. Second, it significantly reduces the amount of premiums earned per policy by the Fund while leaving losses incurred by policyholders unaffected by the discounts. As such, the Fund operates at a level where incurred losses exceed premiums earned. However, as illustrated in Table 5, (page 31) the Fund has relied upon investment income to compensate for these losses, and in effect, finance premium deviations and dividends.

---

(1) Approximately $2.1 million of this investment income was allocated to a group of employers termed self-raters who establish their own loss reserves which are maintained and invested by the Fund.

TABLE 5

STATE COMPENSATION FUND
OPERATIONAL ANALYSIS OF NET INCREASE IN SURPLUS
1987 AND 1986

	1987 (in thousands)	1986 (in thousands)
Premium revenues	$171,834	$149,962
Less compensation and medical benefits paid	162,194	153,496
Excess of premiums over (under) incurred losses	9,640	(3,534)
Operating expenses:		
Administrative	28,247	24,047
Premium taxes	6,892	6,091
	35,139	30,138
Net loss before investment and other income	(25,499)	(33,672)
Investment and other income:		
Investment	56,799	60,847
Other	4,442	2,037
	61,241	62,884
Net gain	35,742	29,212
Less dividends declared	30,000	20,000
Net increase in surplus	$ 5,742	$ 9,212

Source: Auditor General analysis of the Arizona State Compensation Fund 1987 Annual Report.

The Fund's use of investment income to offset its operating deficit and finance annual dividends raises questions about compliance with statutory requirements. A.R.S. §23-983.A requires that the Fund ". . . be neither more nor less than self-supporting." The large reserves maintained to cover future costs of claims provides substantial investment income. However, the Fund may have overstated its needed reserve amounts (see Areas For Further Audit Work, page 75) and may be accumulating unnecessary surplus amounts (see Finding I, page 15). As a result, the Fund is able to finance both operating losses and annual dividends, actions which further improve its competitive advantage over private insurance companies.

Exemptions - As a State agency, the Fund has remained exempt from paying Federal income taxes and from establishing a statutorily required security deposit. However, A.R.S. §23-987 requires the Fund to determine the amount of Federal taxes it would owe as a private insurance carrier. According to the Fund's outside auditors, for the year ended December 31, 1987, the Fund would have owed more than $2 million in Federal taxes.[1] In addition, due to changes in the tax laws and a projected increase in premiums collected, the equivalent Federal tax owed by the Fund for 1988 could be even higher.

In addition to not paying Federal taxes, it appears the Fund is not required to establish a security deposit that is statutorily required of private workers' compensation insurance carriers. A.R.S. §23-961.C requires insurance carriers to place securities approved by the Department of Insurance with the State Treasurer or file an equivalent surety bond. The amount of the security deposit is based on the amount of premiums written by the carrier. However, because the Fund is not expressly mentioned in A.R.S. §23-961.C and there is no clear application of the statute to the Fund, it would appear that the security deposit requirement does not apply to the Fund.[2] Auditor General analysis determined that if the provisions of A.R.S. §23-961 applied to the Fund

---

(1) 1987 was the first year since 1983, when the statute requiring the calculation of Federal taxes became effective, that the Fund would have actually owed Federal taxes. For the years 1983 through 1986, the Fund reported losses sufficient to offset taxable income.

(2) An Attorney General representative suggested that clarification is needed of A.R.S. §23-961 as it applies to the Fund.

as with all other carriers offering workers' compensation insurance in Arizona, for 1988, the Fund would have to place approximately $84.1 million of securities with the State Treasurer. The purchase of an equivalent surety bond would cost the Fund more than $420,000.[1] Such a bond would, however, reduce the amount by which the State is responsible for Fund liabilities.

State subsidies - Advantages to the Fund also include receipt of goods and services that are subsidized by the State of Arizona. Currently, the Fund receives property and casualty insurance coverage through participation in the State's self-insurance program, at a price significantly less than the Fund could probably obtain in the private market. Because Fund employees are part of the State's merit system, the Fund receives certain services from the Department of Administration - Personnel Division, and participates in the State's retirement, health and life benefits programs. Although exempt from the State's procurement code, the Fund benefits from the State's volume purchasing power by periodically making purchases from vendors who are on State contract. Finally, Arizona law requires the Fund to deposit all funds received and make all payments through the State Treasurer. Therefore, the Fund receives these services at no charge and occasionally uses other monies maintained by the Treasurer to cover payments made by the Fund. The subsidies and the estimated dollar benefits to the Fund are illustrated in Table 6 (page 34).

---

(1) In 1988, the Legislature amended A.R.S. §23-961, effective for 1989, changing the method for calculating the security deposit to include loss reserves established by the carrier as well as premiums written. According to calculations by Fund officials, based on 1987 data, if the security deposit requirement had applied to the Fund it would have to place approximately $326.8 million of securities with the State Treasurer. Auditor General analysis calculates that an equivalent surety bond would cost the Fund more than $1.6 million.

TABLE 6

ESTIMATED SAVINGS TO THE FUND DUE TO STATE SUBSIDIES

Agency	Type of Subsidy	Annual Estimated Savings to Fund [a]
Personnel	Participation in health, life and disability benefits programs	$ 1,003,000
	Job recruitment	31,000[b]
Risk Management	Property and casualty insurance	157,000[c]
State Treasurer	Cash management	116,000
State Purchasing	Use of State purchasing contracts and administrative personnel	95,000
TOTAL		$ 1,402,000

(a) While each estimate represents the savings to the Fund over a 12-month period, the data used to establish the various estimates was collected from time periods that ranged from fiscal years 1987 through 1989.

(b) This figure represents State Personnel's estimated cost of $209 per position filled for fiscal year 1986-87 multiplied by 148 (the number of employees hired by the Fund during that period.)

(c) This figure represents the difference between the charges to the Fund from Risk Management for the insurance coverage and the lowest of three estimates for similar coverage from insurance companies obtained through an insurance broker. The differences between the Risk Management charges and the two higher estimates were $172,000 and $225,000.

Source: Auditor General analysis of data obtained from State Compensation Fund, DOA - Risk Management Division, Personnel Division and State Purchasing Office, State Treasurer, and a private insurance broker.

Legislature Should Consider Altering The State's Relationship With The Fund

The changes in the nature and role of the Fund and the environment in which it operates may require changes in the relationship between the Fund and the State of Arizona. The Legislature should consider steps to curtail benefits the Fund receives from its relationship with the State in order to reduce the Fund's competitive advantage over private insurers. The Legislature may also wish to review the need for the Fund given the availability of workers' compensation insurance through the private market.

Curtail benefits - The Legislature should consider curtailing the Fund's exemptions from requirements met by other insurers, and reducing State support of Fund operations that give it a competitive advantage. Exemptions from Federal income tax saved the Fund more than $2 million in 1987. Requiring the Fund to pay the equivalent Federal income tax to the State General Fund would eliminate a substantial competitive advantage.

The Legislature should also curtail State support of Fund operations that give the Fund a competitive advantage. Annually, the Fund benefits from at least $1.4 million in State support for such functions as employee benefits, purchasing, property and casualty insurance, and cash management. Most of these benefits are not directly paid for by taxpayer dollars, but rather are in-kind benefits or savings received by the Fund through its participation in these activities. However, certain services provided to the Fund by State Personnel, State Purchasing and the State Treasurer are subsidized by taxpayer dollars. The Legislature should require the Fund to reimburse those agencies for those services.

Need for Fund - The continued need for the State Compensation Fund is a legislative policy question. As a policy question, arguments can be made for and against continuing the Fund. One argument against continuing the Fund is that the need for which it was created no longer exists. The Fund was established to ensure that workers' compensation insurance would be available to all Arizona employers. However, at least 100 companies now offer workers' compensation insurance, and an assigned risk plan

ensures that all employers will be able to obtain the required insurance.[1]

A second argument is that the Fund's existence is contrary to more recent legislative policy. The Legislature has established a clear policy that limits State agencies from offering services that are available from the private sector. A.R.S. §41-2752 prohibits State agencies from competing with private enterprise unless authorized by law. Although the Fund is specifically authorized to offer such services, the need for the Fund to do so has been lessened by the changes in the workers' compensation market since 1969.

Arguments for continuing the Fund include the fact that it provides significant benefits to some Arizona employers. Because of its large market share and investment portfolio, many employers pay lower premiums and receive dividends through the Fund. These benefits may not be widely available from the private sector. The Fund also appears to insure the majority of Arizona employers engaged in hazardous industries such as underground and surface mining, logging, and aircraft operations. The Fund's willingness to insure these employers enables them to avoid the higher costs of assigned risk insurance. Finally, because of its large market share, discontinuing the Fund could disrupt the supply of workers' compensation insurance in Arizona.

RECOMMENDATIONS

1. The Legislature should consider amending A.R.S. §23-987 to require the Fund to annually pay to the State General Fund an amount equivalent to the Federal income tax it would owe as a private company.

---

(1) Twenty states have compensation funds. The 30 other states rely solely on the private insurance market to provide workers' compensation insurance. In the last 45 years, two states have established compensation funds, Minnesota in 1983 and Hawaii in 1985. However, the Minnesota Fund is incorporated as a mutual insurance company, subject to the same regulatory controls as private insurers, including the payment of Federal income taxes. The Hawaii Fund has yet to begin operations due to a lack of legislative funding.

2. The Legislature should consider requiring the Fund to annually identify and reimburse various State agencies for the full cost of services received by the Fund which are paid for with taxpayer dollars.

3. The Legislature should consider:

   - The need for the Fund given the availability of workers' compensation insurance through the private market.

   - Whether the State should compete with private insurers to provide workers' compensation insurance.

FINDING III

THE STATE COMPENSATION FUND CAN SIGNIFICANTLY IMPROVE ITS CLAIMS MANAGEMENT BY ADOPTING PROCEDURES USED BY THE PRIVATE SECTOR

The State Compensation Fund (the Fund) does not employ procedures commonly used by private companies to manage claims. Claims are not assigned to staff in a way that ensures appropriate expertise or equal workloads. Moreover, the Fund's supervisory reviews, investigations and medical management procedures are weak. More active claims management may reduce claims costs and ultimately reduce the costs of insurance to policyholders.

The Fund paid over $162 million for claims during 1987. The Fund's claims department evaluates claims and determines the amount of medical benefits and compensation to be paid to policyholders' employees with work-related injuries. There are two major categories of claims: (1) claims for the costs of medical treatment of employment related injuries or diseases and (2) claims for time lost from work (indemnity claims) which may also include payment of medical costs. Claims involving lost time are more difficult and time-consuming to handle than claims for medical costs only.

State Fund claims representatives evaluate claims to determine if coverage applies and to determine appropriate amounts. As of June 1988, the Fund had 93 staff in its compensation unit, which processes claims. Representatives need to have technical expertise to adequately evaluate claims in order to process them in a timely manner and take other actions to contain medical and compensation costs.

Claims Are Not Assigned In An Effective Manner

The Fund's method of assigning claims to its representatives may not be effective. The current assignment method does not match the complexity of cases with the representatives' experience as is done by companies

reported to have some of the best claims management practices. In addition, the Fund does not transfer cases if the complexity of the cases changes.

The Fund assigns claims based on the policyholder/employer's location and name. For example, a claim made by an employee of "Acme Company" in Glendale would be assigned to the desk handing policyholders whose names begin with the letter A in the Glendale Unit. This method does not distinguish among representatives' ability and experience. Instead, representatives handle all claims for the location and alphabet they are assigned. Thus, a new representative with little experience may handle extremely complex and difficult claims, such as head, back, and paralyzing injuries that can result in permanent disability with potential for high compensation, medical and other costs.

In contrast, private workers' compensation insurers we contacted and the Workers' Compensation Fund of Utah assign more complex and difficult claims to their more experienced representatives. We asked an independent consultant specializing in workers' compensation claims to identify companies which managed claims particularly well. She recommended five companies and we contacted each of the five. Claims officials at each of these five private workers' compensation insurance companies indicated that they made assignments based on severity of the claims and representatives' experience. According to these officials, assigning cases in this manner ensures that representatives with greater expertise handle the claims that have the higher potential costs.

The Fund also does not transfer cases if they become more complex. Private carriers reassign cases to more experienced representatives if payment or reserve amounts escalate, indicating that a case is becoming more complex. In addition, at least one company we talked to transfers

cases to less experienced representatives once an award is made and the case requires little monitoring, thus allowing experienced claims representatives to concentrate on cases that most require their skills.

Fund officials cite one major reason for not reassigning cases. They state that claims representatives establish rapport with policyholders which maintains good policyholder relations. However, while the Fund rarely reassigns claims based on changes in their status or to redistribute the workload, our review of Fund reports shows that it frequently reassigns files because the employer changes location or name. Between April 1 and June 30, 1988 the Fund transferred 563 claims among representatives.

More Supervisory Review, Better Investigations And Stronger Medical Management Procedures Are Needed

The Fund's procedures for managing claims often do not follow standards generally used throughout the insurance industry. Supervisory review appears to be limited. Many claims are not investigated thoroughly or in a timely manner. Moreover, the Fund makes little effort to manage the medical aspects of its claims.

Limited supervisory review - The Fund does not effectively review claims processed by its staff. Although some review guidelines have been recently developed, they are more limited than review requirements used by private insurance companies.

Prior to 1988, supervisors did not regularly review all claims files. Files were generally reviewed by supervisors only when representatives solicited their advice.[1] Beginning in January 1988, supervisors

---

(1) In a memorandum reportedly circulated to claims representatives during initial training, the Fund has established 12 criteria for obtaining supervisory review. A review of these criteria indicates that in all cases the supervisor must rely on the claims representatives to identify those instances in which supervisory review is called for. In addition, the majority of these 12 criteria involve administrative processing of the claim and do not require the supervisor to actually review the claim file. As such, the 12 criteria do not represent regular supervisory review which can identify potential problems and allow the Fund to take appropriate steps to prevent unnecessary claims costs.

were directed to randomly "audit" 9 or 10 files from each desk every month. In January of 1989, the Fund plans to begin requiring supervisors to review all cases older than 120 days.[1] According to Fund officials, programming is currently being developed for the Fund's computerized claims processing system which will allow it to alert claims supervisors of all claims which are 120 days old or have reached total payments of $10,000, $25,000 and $100,000.

Regular supervisory review can identify potential problems and allow the insurer to take appropriate steps to prevent costs from escalating unnecessarily. The private carriers surveyed have methods to assure all or most cases are seen by supervisors at regular intervals (Table 7, page 43). These companies generally use two criteria for review. One criterion is based on the length of time cases remain open or periodic review of all open cases. The second criterion is the reserve amount, or what the company expects a claim to cost. Generally older cases or cases where expected costs exceed certain levels are targeted for review.

---

(1) According to the Fund's Claims Manager and former Claims Training Supervisor, the Fund currently requires supervisory review of certain claims once they reach 120 days. However, this review is limited to <u>only</u> those claims which the claims representative identifies and believes could result in a permanent impairment award.

TABLE 7

SUPERVISORY REVIEW GUIDELINES FOR SELECTED PRIVATE WORKERS' COMPENSATION INSURANCE CARRIERS

Company	Age of Claim	Amount of Reserves
A	All files open more than 180 days	At $20,000 local office manager reviews At $100,000 home office management reviews
B	All files within first 30 days; thereafter as necessary	Supervisor and manager review reserves monthly
C	All files every 90 days	Supervisor reviews when reserve amount reaches specified limit for representative
D	All files every 120 days	Supervisor reviews monthly report of reserves; manager reviews at $75,000
E	All files every 30 days except permanent payment cases[a], which are reviewed every 90 days	At $25,000 supervisor reviews

(a) Permanent payment cases are those where awards have been issued and payments are made on a regular basis.

Source: Compiled by Auditor General staff from information obtained from the companies in June, 1988.

Poor claims investigations - The Fund does not adequately investigate claims for compensation payments. Several audits of the Fund's claims management have noted that investigations are often not done or are inadequate. The Fund's lack of attention to this important aspect of

claims management contrasts with common practices within the insurance industry and can result in accepting inappropriate cases.

Audits of the Fund's claims processing have consistently identified inadequate investigations as a problem, particularly for the more complex claims involving time lost from employment. The Arizona Department of Administration Risk Management Division (DOA-Risk Management) review of claims against the State's self-insurance program[1] in 1985 found that the Fund's claims representatives rarely made needed initial telephone inquiries to employers, claimants, and witnesses. In addition, DOA concluded that when claims representatives requested special investigations from Fund investigators, the results were usually late and poorly documented.[2] Two years later DOA found that investigations were still infrequent, typically made at the request of employers or in unusual cases.[3]

The National Council on Compensation Insurance (NCCI) found similar deficiencies in 1987 when it audited the Fund's assigned risk claim files. NCCI found the Fund's investigations were often untimely and poorly documented. According to the report, the Fund failed to document that basic investigative steps were taken within standard time frames. The report also noted that contact with employers ". . .consisted mainly of wage verification and time loss determination with only cursory discussion of injury . . ." and that investigators' contacts with physicians often did not document what caused the injuries. Further,

---

(1) The State Fund processes workers' compensation claims for DOA-Risk Management. To ensure that claims are processed in a timely, efficient manner, DOA contracts with a specialist in workers' compensation claims management to review selected claims and evaluate Fund's performance.

(2) According to Fund management, the Fund's investigations section solicits feedback on the quality and timeliness of investigations from claims and legal staff requesting investigations. The results of this survey indicate that those requesting investigations are satisfied with the quality and timeliness of the investigations. However, this survey does not define what constitutes timeliness of each investigation, nor does it consider the complexity of each investigation.

(3) Our review of the 1987 DOA audit disclosed that of the claims cases DOA reviewed and felt warranted an investigation, 80 percent had untimely investigations, 83 percent had inadequate investigations, and 76 percent contained no investigation report in the claim file.

representatives had not documented prior injury investigations where necessary.

Thorough, timely investigations are an important component of claims management. One insurer emphasized that an initial investigation must be done "quickly and completely" before making a decision to accept or deny a claim. Generally, initial investigations at the private companies surveyed by Auditor General staff include contacting the claimant, employer, witnesses, and the treating physician within a few days of receiving a claim. Failure to adequately investigate a claim completely can lead to unnecessary costs as shown in the following example.[1]

CASE 1

An electrician for a State institution filed a claim for a hernia reportedly sustained on July 14, 1987. The employee reported the injury to his employer and obtained initial medical treatment for the injury on August 28, 1987, 45 days after the reported date of injury. The claimant underwent surgery for the hernia on September 8, 1987. The only investigation of the claim was a phone call to the claimant who stated that he did not immediately realize he had hurt himself and discovered the hernia lump sometime later. The claimant also said that he reported the injury after seeing his doctor on August 28, 1987 and then had to talk with his supervisor to determine the date of the injury. The claim file contains no documentation of further attempts to investigate the circumstances surrounding the injury and why the claimant waited 45 days to obtain medical attention and report the injury to his employer. On October 5, 1987, the Fund accepted the claim for benefits.

Comment: The initial investigation was inadequate because the claims representative did not obtain sufficient information to evaluate the claim. The representative only contacted the claimant, not the employer or treating physician. In addition, the representative apparently did not review State law governing the compensability of hernias which requires that the injury result from a specific event and that the onset of symptoms occur immediately after the event. According to Risk Management officials, this condition did not meet the requirements of A.R.S. §23-1043 that define compensability. Failure to conduct an adequate investigation resulted in the acceptance of a non-compensable claim, which cost the State of Arizona more than $2,700 in benefits.

---

(1) In their response to the initial draft of the audit report, Fund officials contended that a late investigation report does not necessarily result in the acceptance of an invalid claim since the claim can be denied and later accepted if the investigation report resolves the basis for the initial denial. However, according to an Industrial Commission official, denying a claim under these circumstances would probably constitute an unfair claim processing practice violation as defined by A.R.S. §23-930 since the denial would knowingly be based on incomplete information.

Inadequate medical management - The Fund does not adequately manage the medical aspects of its compensation claims. Claims representatives and investigators rarely solicit information about claimants' prior medical conditions. Moreover, the Fund lacks medical staff for evaluating cases and makes limited use of second opinions.

- Claims representatives and investigators rarely solicit pertinent medical records. For example, the 1985 and 1987 DOA audits found that several claimants had undergone surgery prior to the injury for which they sought compensation, yet no medical reports or records were solicited to determine if the previous medical problem affected the new claim. No medical histories were sought in 82 percent of the files sampled in 1987 in which DOA felt prior medical information should have been solicited. DOA's criteria states that a claimant should be queried about medical history, particularly if the attending physician states that the claimant's history may be a significant factor affecting recovery.

  The five private carriers we spoke to use criteria similar to DOA's. They obtain medical records in instances, such as when there is 1) an indication of a prior injury or condition that could impact the indemnity claim, 2) a possibility of permanent impairment, or 3) the injury is severe. One company solicits records for all claims of any significance, such as cases where the time lost from work is more than 14 days. Another company obtains records for all time lost claims.

- The Fund also lacks medical expertise needed for effective claims management. Unlike many workers' compensation insurers, the Fund does not employ nurses or other medical professionals to assist in making judgments about claims. Nor does the Fund make adequate use of independent medical examinations to obtain second opinions.

  Private insurers use nurses to visit claimants, talk to physicians, and review medical records in order to evaluate claims and direct treatment. Nurses are used because they have the expertise to watch for and identify improper or non-related treatment, assess a

claimant's progress, and coordinate any rehabilitation that may be required. In particular, other insurers refer certain types of cases to nurses or other medical professionals. These cases include: injuries involving loss of earning capacity, cases without firm diagnoses after 60 to 90 days, and cases involving catastrophic injury, trauma, and/or extended medical treatment. DOA-Risk Management recommended in its 1985 and 1987 audits that the Fund use nurses to manage medical claims.

Several state workers' compensation agencies also make extensive use of medical personnel. The Oregon State Accident Insurance Fund (SAIF Corporation) has one to four nurses in each of its six offices, an orthopedic surgeon on staff, and contracts with several other physicians. The Minnesota State Insurance Fund uses a subsidiary organization, which has a physician, chiropractor, and six nurses to manage medical claims.

The Fund maintains it uses the services of a utilization review organization to assist in medical management of claims. However, this service is limited to determining whether hospitalization is required for a specific procedure or condition. It does not constitute the on-going medical management used by private insurers and other sates.

- Past audits and reviews have also recommended that the Fund make more use of independent medical examinations (IMEs). DOA-Risk Management recommended this approach in 1985 and 1987. The Fund's internal auditors found in 1987 that medical care was "fragmented or non-directed" and recommended IMEs as a means for improving medical management. In May 1988, the Fund established an IME unit responsible for assisting claims representatives in scheduling IMEs and obtaining reports of the examinations. However, this unit has no responsibility for determining when IMEs are needed.

Independent medical examinations strengthen an insurer's ability to manage medical aspects of workers' compensation claims. According to officials interviewed at the five private companies and state funds in Utah, Oregon, Minnesota, and California, IMEs should be ordered in a variety of circumstances where there are questions about the nature of the medical problem or effectiveness of the treatment.

Effective Claims Management Can Reduce Costs

More active claims management is necessary to effectively reduce the costs of workers' compensation insurance to policyholders. Actions taken by the Department of Administration to ensure that the Fund adequately manages State workers' compensation claims appear to have reduced costs to the State's self-insurance program.

Failure to manage claims increases costs - Failure to use good claims management practices can result in unnecessary costs, as illustrated in the following examples:

CASE 2

On May 29, 1982 a worker at a State medical facility reportedly was injured while attempting to restrain a patient. The Fund accepted the claim 10 days later. Shortly after accepting the claim, the Fund received reports submitted by the claimant's physician, a consulting physician, and a psychiatrist that described different injuries and circumstances than cited by the claimant.

The claims representative requested an orthopedic medical evaluation in April 1983. On May 23, 1983, the claims representative received the results of the orthopedic evaluation in which the doctor concluded that the claimant had a back strain but no apparent evidence of disc disease. The doctor expected the claimant to become stable within the following 30 days with no permanent physical impairment.

On June 14, 1983, the claimant was again hospitalized for back pain. An orthopedic examination found that the claimant continued to suffer from a back strain but concluded the claimant's major problem was psychiatric in nature.

In July 1984, more than two years after the claim had been accepted for benefits, the claims representative learned that the claimant had been treated for a nearly identical injury in another state and had received a $20,000 settlement.

DOA-Risk Management referred the claim to a private rehabilitation firm for medical management in August 1986. The claim was closed on February 17, 1987 after the claimant had been discharged by his physician with no permanent disability. The claimant appealed this action to the Industrial Commission which sustained DOA's decision.

Comment: Inadequate claims management was evident at least three times during the duration of this claim. First, the discrepancies in injuries and circumstances reported when the claim was filed should have led the representative to investigate the facts. Second, the representative should have taken action to close the case upon receipt of the May 1983 orthopedic report, indicating that the claimant's back problems were limited. Third, the evidence of a nearly identical claim in another state was another reason for action. Instead, the claimant was allowed to continue treatment for three more years at a cost of almost $90,000, bringing the total costs of the claim to $147,700.

CASE 3

A State employee filed a claim for a work-related back injury in December 1983. The employer informed the Fund claims representative that the claimant (a) had had four previous back surgeries, and (b) had previously made statements that she might seek disability based on these prior surgeries. Neither the claimant nor employer was able to establish a specific date of injury. The Fund claims representative also received a report from the claimant's physician describing four previous back surgeries and a non-industrial back injury. The claim was accepted by the Fund on February 1, 1984. No investigation was conducted nor were prior medical records obtained.

For the next 15 months the claimant was seen by five doctors and continued to complain of chronic back pain although most of the doctors could find little or no physical explanation for the pain. One doctor indicated that the claimant could return to work.

In April 1985 an independent medical examination by four physicians concluded that 1) the claimant's condition was stable, 2) there was no evidence of permanent impairment, and 3) the claimant was capable of returning to the type of work done prior to the reported injury.

However, in June 1985 the claimant's physician informed the Fund that the claimant needed back surgery but refused to say whether the surgery was related to the claimant's prior back surgeries or to the reported injury. Although other medical and psychological reports questioned the need for the surgery, surgery was performed in October 1985. The claimant developed serious post-operative complications and continued to complain of back pain.

In March 1986 DOA-Risk Management intervened and directed the Fund to refer the claim to a private rehabilitation firm and closed the case in April 1987. The claimant appealed the decision to the Industrial Commission (ICA) which ruled that:

- The claimant's condition as attributed to the reported industrial injury required no further treatment after April 1985.

- The claimant had not sustained any permanent impairment as a result of the reported industrial injury.

- The October, 1985 surgery was not related to or required by the reported industrial injury, although the surgery and all resulting problems were treated and paid for as an industrial responsibility by the Fund.

Comment: Intervention by DOA-Risk Management appears to have resolved this poorly managed claim. According to Risk Management officials, the claim representative failed to close the case when the independent medical evaluation team found the claimant capable of returning to work in April 1985. The subsequent authorization of surgery resulted in thousands of dollars of unnecessary medical and compensation expenses which, according to the ICA award, were unjustified by the circumstances. The State paid $99,200 as a result of the October 1985 surgery.

DOA experience - The Department of Administration has actively reviewed the Fund's management of workers' compensation claims against the State's self-insurance program. Since 1985, DOA has audited claims against the State's self-insurance program and has also requested the Fund assign experienced claim representatives and legal staff to manage State claims. DOA's review results in more active claims management for State claims than other Fund policyholders receive.

Results from DOA's efforts suggest other Fund policyholders would benefit if the Fund provided more claims management. According to Risk Management officials, actual benefits paid by Risk Management have been significantly less than the payments forecast by its outside actuaries. The actuaries forecasted payments of $8.6 million by June 1988. However, actual benefit payments at that time were only $6.8 million, 21 percent less than expected.

The reduction occurred during a period when Risk Management officials indicated events should have increased Arizona's compensation payments: (1) the limits on hospital and physician charges were increased; (2) the maximum wage benefits that could be paid were increased; and, (3) the number of employees covered by Risk Management increased. All of these should have increased the benefits paid by the State for workers' compensation benefits.

RECOMMENDATIONS

1. The Fund should assign claims to employees based on the complexity of the claim and the employee's experience and expertise.

2. The Fund should develop a clear policy for supervisory review of claims, including

   - Review criteria based on age of cases and projected costs.

   - Identification of specific areas for review.

   - Continue the development of information systems to identify claims that meet the review criteria.

3. The Fund should establish specific guidelines to ensure that each claim receives at least a minimum level of investigation. Guidelines should also provide direction for additional investigation for more complex or potentially costly claims.

4. The State Fund should strengthen medical management of claims cases by

   - Ensuring that claims representatives obtain complete medical histories for all claims where prior conditions may contribute to the current disability or likelihood of recovery.

   - Hiring nurses or other medical professionals to assist claims representatives in evaluating medical treatment.

   - Developing guidelines identifying situations where use of medical staff is warranted.

FINDING IV

SIGNIFICANT WEAKNESSES EXIST IN ACCESS CONTROL AND DISASTER RECOVERY PROCEDURES OF THE FUND'S COMPUTER SYSTEMS, INCREASING THE RISK OF FRAUD OR ABUSE

Significant weaknesses exist in two critical controls of the State Compensation Fund's (the Fund) electronic data processing system. Computer access controls and physical security are weak, exposing the Fund to potential fraud and abuse. In addition, disaster recovery control procedures are inadequate.

The State Compensation Fund relies heavily on its electronic data processing (EDP) system for many operations, such as processing claims and payments and maintaining policyholder records. Computerization allows quicker and more efficient data storage, manipulation, and retrieval. In 1987, the Fund processed approximately 57,000 compensation claims. The Fund also processed approximately 335,500 checks (representing compensation and medical payments, general disbursements, payroll, and dividends), amounting to nearly $704 million.[1] Furthermore, the computer system maintains confidential information on current and prior policyholders and claimants.

Auditor General EDP staff reviewed the Fund's computer system because the Fund relies extensively on EDP and its data was used in the audit. The auditors concentrated on the adequacy of general controls used to provide reliability of, and security over, the data being processed.

---

(1) This amount includes benefit payments for self-insured accounts, assigned risk claims, and claims from prior years.

Access Controls And Physical Security Are Weak

The Fund does not adequately protect computer operations from unauthorized access. Lack of adequate control creates a high exposure to potential fraud and abuse.

Access controls - Protection against unauthorized access to computer data should be standard practice to guard against possible fraud and abuse. The Fund, however, does not use adequate security measures to control computer access even though these measures are already available. Normally, users should be able to gain access to computerized information only through established passwords and authorization procedures. However, claims processing staff are not required to log on or enter passwords. The Fund's management information system (MIS) staff are required to log on and enter passwords. However, they circumvent this control by using predefined keys ("hot keys") which automatically supply this information to the terminal.

An adequate control system should also be capable of identifying and logging attempts at unauthorized use. For example, attempts to gain access by entering invalid passwords should be logged and the terminal disconnected or the keyboard locked after several unsuccessful attempts to gain entry. Jobs submitted for execution should be monitored so that any unauthorized attempts would be detected and the related job cancelled. No such controls are in place at the Fund.

Further, according to the Fund's MIS staff, reports of terminal activity (reports identifying those accessing computer data and what they do with it) are seldom produced. EDP management should regularly prepare and review these types of reports to detect unauthorized computer operations, thus providing a control over computer use.

Easy access to computer data and insufficient monitoring of terminal use increase the risk of fraud. Although Fund management maintains the risk of fraud is low because they can track changes to claims information, we found some changes to claims information are recorded and maintained for only a short period of time, while other changes to data are simply not tracked. For example, changes made to addresses and benefit termination dates are not tracked. In addition, a transaction file used to

record other changes does not maintain a history of changes to a particular claim. Lack of adequate control could make it possible for employees to manipulate claim file information. For example, employees could change address information, thereby diverting payments to fictitious people, or to themselves. Studies of computer-related crimes in the Federal government substantiate this risk. These studies found: 1) most computer frauds involve manipulations in benefit or payroll systems (i.e. systems similar to the Fund's), and 2) a good system of controls would prevent these cases or lead to their detection.

Fund officials state that they rely on their internal EDP auditor and their external financial auditors[1] to deter abuse. To date Fund management is unaware that any fraud has been committed. However, reliance on internal and external auditors does not appear to provide adequate protection against potential fraud. The Fund's external auditors do not specifically test for computer fraud and the Fund's own EDP auditor performs minimal testing to identify irregularities or crimes.

Physical security - The Fund does not adequately protect access to vital computer operations and program documentation. Access to computer operations should be available only to authorized persons to protect the facility. Each entrance should have some form of restriction such as keys, cipher locks, magnetic cards, voice/hand print identification systems, or security personnel. While the Fund has a cipher lock on the door to the operations area, Auditor General staff observed it unlocked and unattended on several occasions, allowing easy access by unauthorized persons. (Although the Fund has recently begun to replace the cipher locks with a magnetic card system, this system was not fully functional when we reviewed it in November of this year.)

Access to written copies of the computer programs (documentation) is also not adequately restricted. The Fund's documentation is kept in an unlocked room with easy access. An Auditor General EDP auditor observed

---

(1) The Fund contracts with a public accounting firm to conduct an annual audit and prepare financial statements.

employees entering this room to obtain supplies, which are also kept there. Restricted access to documentation is necessary since it contains information necessary to make changes to programs and data file structures. Organizations should maintain protected documentation libraries and restrict access.

Finally, some Fund programmers have access to the computer room. According to industry standards, this situation is unacceptable. Good controls dictate a segregation of functions between computer systems analysts and programmers on the one hand, and computer operators on the other. Ideally, the computer room should be restricted to computer operating personnel; systems analysts and programmers should not be allowed to enter. This restriction provides a safeguard by making manipulation of files and programs difficult by systems designers and programmers.

Disaster Recovery Controls Are Inadequate

Although necessary and important, the Fund lacks controls for computer disaster recovery. Disaster recovery plans help ensure that business can continue in the event of an EDP catastrophe. Disastrous events can be intentional (e.g., bombings, fires), natural hazards (e.g., hurricanes, tornadoes, floods, earthquakes), or acts of negligence (e.g., dropping a disk pack). Because the Fund is highly dependent on its computer system, adequate contingency plans must exist. Planning is necessary to ensure that adequate security measures and controls are maintained both during and following a computer disruption. The Fund, however, lacks an adequate plan, the result of which could significantly impair its normal operations.

The Fund's current EDP disaster recovery plan is inadequate. First, no written disaster recovery plan exists. Secondly, the Fund has informal arrangements with an organization to use its computer, but has not determined if the facility could adequately process Fund data.

Furthermore, this unwritten agreement does not include pertinent information like the amount of time the Fund could use the computer, how frequently it would have computer access, or how long the arrangement could be maintained.

The Fund, however, recently took steps to develop a disaster recovery plan. Fund officials estimate that the plan will be fully implemented in early 1989. Once a plan has been developed, the Fund should thoroughly test it to ensure that it is workable and that expected contingencies are adequately addressed. Test results should be documented for proper review and corrective action. In addition, Fund management should ensure that the plan is kept current and complete.

RECOMMENDATIONS

1. The Fund should establish, document, and continually enforce security controls over computer access, including

   - Imposing access restrictions by issuing individual passwords required for system access.

   - Strictly enforcing restrictions on access to operations area and to written program documentation.

   - Regularly producing and reviewing reports on terminal activity.

2. The Fund should develop an auditing plan for its EDP system throughout the year. Auditors should evaluate risks and identify potential opportunities for system abuse. Procedures for reducing the risk of fraud include

   - Random case validation

   - Identification of workers' transactions in the data base

   - Limiting system access

   - Enforcing security features

3. The Fund should develop a written disaster recovery plan that:

   - Identifies critical computer applications

- Provides step-by-step plans defining organizational unit responsibilities
- Identifies outside locations where EDP operations may continue
- Specifies security controls needed during recovery

FINDING V

THE FUND HAS NOT BEEN FISCALLY RESPONSIBLE IN SOME AREAS

The State Compensation Fund (the Fund) has demonstrated questionable fiscal responsibility in some areas. The Fund appears to have evaded statutory requirements in purchasing several office buildings. Furthermore, expenses for employee awards and education benefits seem excessive and, in some cases, may constitute gifting.

The Fund Has Not Complied With Statutory Requirements During Building Purchases

The Fund did not meet statutory provisions while purchasing some office buildings. Recently, the Fund bought three office buildings to house its business operations. Although State law grants the Fund authority to buy real property, the Fund did not adequately comply with either capital outlay budgeting[1] or investment provisions.

Fund building purchases - During 1986, the Fund purchased, for cash, several office buildings for its operations. The largest was the Abacus Towers, located in uptown Phoenix, purchased in late 1986 to house the Fund's home office operations. The Fund paid approximately $31.5 million for the 250,000 square foot building with improvements. In addition, the Fund bought two other buildings during the year, to house district operations in Mesa and Show Low. These buildings cost the Fund approximately $1.5 million.

Budget requests not prepared - State law requires Joint Legislative Budget Committee (JLBC) approval for Fund capital outlay expenditures. The Fund, however, did not submit this required budget information to JLBC on its building purchases. Instead, the Fund presented the building purchase to the JLBC chairmen as an investment - something which would not need JLBC approval.

---

(1) Capital projects include real property such as land, buildings and improvements.

Real property acquisitions require JLBC approval. Arizona Revised Statute §23-981(D) states that the Fund Manager . . .

> "may lease or acquire real property and acquire or construct buildings or other improvements on the property as are necessary to house, contain and maintain offices and space for its departmental and operational facilities."

However, paragraph E of the statute requires the Fund to prepare and submit a "capital outlay budget . . . for review and approval by the Joint Legislative Budget Committee . . ." According to JLBC officials and our review of Fund budget documents, the Fund did not submit capital outlay budget requests for any of the three buildings. Furthermore, a review of JLBC committee minutes did not show any discussion or action taken by the committee regarding the purchase of these buildings.

Instead of submitting a capital outlay request for the Abacus building, Fund management informed JLBC chairmen that the Fund was purchasing the building as an investment. A September 15, 1986 memo from the Fund Manager to the Board and Investment Committee notes that the Fund Manager met with JLBC chairmen to outline " . . . the Fund's actions to date regarding the purchase of a building under the investment provisions of the Insurance Statutes, Title 20." (emphasis added) Such an action would not require capital budget review and approval.

No formal investment resolution - Fund officials contend capital outlay budgets were not prepared because the buildings were purchased as investments, as noted above. In addition, in a letter to Fund policyholders announcing the Abacus purchase, the Chairman of the Board of Directors and Fund Manager stated investment monies were used to purchase the building. However, at the time of the building purchases, long term investments of Fund monies required formal action by its Investment Committee. The Committee did not resolve to buy any of the buildings. [1]

A.R.S. §23-985 creates the Fund Investment Committee and outlines the Committee's purpose. According to the statute, the Investment Committee

---

(1) We found no record that the Fund sought Investment Committee approval for the Mesa and Show Low building purchases.

shall "establish investment policy and supervise the investment activities of the state compensation fund." The statute further specifies that "the investment committee, by resolution, may invest and reinvest the surplus and reserves of the state compensation fund in any legal investments authorized under Title 20 . . ." (emphasis added).

Our review of the Abacus purchase shows:

- The purchase was underway before the matter was brought to the Investment Committee for a vote. Board minutes show that Fund management had begun negotiations and initiated escrow proceedings by the date of the Investment Committee meeting.

- The purchase ran counter to the Investment Committee's written investment policy stating that all available monies "are to be invested in fixed income securities" (bonds, for example). Buildings are not fixed income securities.

- Investment Committee minutes do not show that the Committee evaluated the Abacus purchase as compared to other investment alternatives.

- Finally, the Committee did not vote to purchase the buildings as an investment. Although the Committee normally used formal resolutions to authorize investments, no such resolution authorizing the Abacus purchase as an investment was passed at the September 19, 1986 committee meeting. However, the Committee did approve four resolutions authorizing other investments at that same meeting. Instead, the Committee passed a motion ". . . to advise the Board of Directors that the Investment Committee sees no reason to oppose the building purchase with the understanding that the Board has a firm basis for its decision." (emphasis added) According to one committee member, this language was used because 1) Committee members disagreed about purchasing the building as an investment, and 2) the Committee was informed by Fund officials that the purchase was actually a decision to be made by the Board of Directors, not the Investment Committee.

Employee Awards And Training And Education Benefits Appear Excessive And May Be Illegal

In addition to the buildings, other Fund expenditures are questionable. Employee awards and related training expenses may be improper. Furthermore, the Fund's employee education policy appears excessive.

Employee awards and benefits - Some expenses resulting from Fund training seem extravagant, and may be unlawful. Use of Fund monies for some training activities seems inappropriate as well as illegal.

The Fund holds several training events for its employees annually. The largest event, referred to as the "Institute", is one to one-and-a-half days in duration. All grade 15 and above staff (identified as professional staff), or about 350 persons, attend the event. According to the Fund's training and education administrator, this function provides opportunities for management to 1) update staff on Fund operations, 2) foster communication among its professional staff, 3) train and motivate staff, and 4) recognize top employees. The 1987 and 1988 Institutes were held at a major Phoenix hotel. Total costs for the event were approximately $52,600 in 1987 and $60,700 in 1988 (Table 8, page 63).

Although the reasons given for holding the event seem reasonable, many resulting expenses do not. For example:

- The Fund invites and pays for the meals and lodging of officials from neighboring states.

- Each Institute concludes with an evening banquet and dance at which outstanding employees are presented such awards as engraved plaques, Seiko watches, Pierre Cardin luggage, and leather attache cases.

- Lodging is provided free to all employees attending the event, including those living in the Phoenix metropolitan area.[1]

---

(1) Room rates for the 1988 Institute exceeded the Department of Administration's per diem lodging amount by $37. According to the Fund's training and education administrator, some Phoenix area employees, at their option, reimbursed the Fund by approximately this amount. However, the Phoenix area employees were not eligible for <u>any</u> per diem as they were not on travel status.

Table 8 shows costs for both the 1987 and 1988 Institutes.

TABLE 8

STATE COMPENSATION FUND
INSTITUTE EXPENSES - 1987 AND 1988

Expense description	1987	1988
Food and beverages[a]	$24,109	$22,200
Lodging[a]	6,014	14,742
Professional services[b]	17,159	15,567
Awards -		
Seiko watches	675	639
Plaques, engraved	894	1,342
Leather attache cases		746
Pens		923
Pierre Cardin luggage	186	
Other awards[c]	2,721	3,449
Miscellaneous -		
Fortune cookies and chopsticks[d]		654
Arrival gifts for guests		257
Table centerpieces	607	
Popcorn machine rental	96	
Other	160	168
TOTAL EXPENSES	$52,621	$60,687

(a) Amount is net of employee spouse/guest reimbursements to the Fund.

(b) Professional services in this table includes speaker fees, audio visual equipment rental fees, meeting room fees, and other similar items.

(c) Other awards are those given to all Institute attendees. For 1988, these awards were pocket planner/calendars; for 1987, business card holder/address books.

(d) During the 1988 Institute, the Fund had specially prepared fortune cookies, the fortunes engraved with outstanding employee names and the chopsticks engraved with the Institute's theme.

Source: Prepared by Auditor General staff using Fund Training and Education financial reports.

Some of these expenses, especially for the awards, appear to violate constitutional and statutory provisions. Article 9, Section 7 of the Arizona Constitution provides that "Neither the State, nor . . . [any] other subdivision of the State shall ever . . . make any donation or grant, by subsidy or otherwise, to any individual, association, or corporation . . ." (As indicated in Finding I, Fund monies are public monies.) A.R.S. §38-601 provides that State officers or employees of any State institution. . ."shall not, under any pretext receive any salary or emolument in excess of the salary so provided."

Other expenses, if not gifts of public monies, appear to be extravagant. For example, in addition to the Institute, in 1988, Fund management hosted a $1,000 luncheon at the Fund's home office for those employees not invited to attend the Institute. Fund officials considered the get together an appreciation luncheon. No training occurred during the meal. This expense, along with all Institute expenses, was charged to the training and education budget category.

Furthermore, the Fund occasionally hosts other functions each year. Two such events include executive meetings, meals included, and luncheons to honor graduates of various in-house training and development courses. The Fund spent nearly $7,500 on six such occasions from January 1987 through June 1988.

Fund officials, however, contend these expenditures are necessary for Fund operations and allowable under A.R.S. §§23-981(C) and 23-981.01(B). A.R.S. §23-981(C) states "the [Fund] manager has full authority over the fund and may do all things necessary or convenient in the administration of the fund . . .", and A.R.S. §23-981.01(B) provides the Fund Manager such powers as are necessary to carry out the functions of the Fund. However, Fund statutes do not appear to provide specific authority for these expenditures.

Excessive education benefits - The Fund may also be misusing monies in its employee education program. Fund policy allows for generous education benefits to its employees. These benefits, though, are significantly greater than that provided to employees of other Arizona agencies.

The Fund provides significant education benefits to its staff. According to Fund policy, the Fund usually pays in advance, for work related educational courses. The Fund will also pay in advance for employees to obtain undergraduate and graduate degrees. Specifically, the employee development program provides full payment for registration, tuition, books and other school costs for Fund employees past the six-month probationary period.

Some employees have benefited greatly as a result of this policy. Although not required by the Fund to obtain college degrees, the Fund has paid for some employees to pursue undergraduate and graduate level degrees. For example, from November 1985 through mid-1988, the Fund spent approximately $27,300 on four employees pursuing business degrees at a local university. One employee alone received nearly $11,000 from January 1987 through February 1988. At one point in 1988, the Fund prepaid the school $2,040 to register this employee in eight classes. This was done to avoid an anticipated tuition increase. The employee left employment with the Fund shortly thereafter and did not complete the courses. Although the school reimbursed the Fund approximately $700 of the $2,040, the Fund had no plans, at the time of the audit, to pursue reimbursement from the individual.[1]

Fund education benefits appear much greater than that provided by most other Arizona agencies. The Department of Administration's (DOA) staff development and training section studied fiscal year 1987 tuition policies of 24 major State agencies.[2] Our review of DOA's summary report indicates all 24 agencies operate on a reimbursement basis, rather than paying for costs in advance like the Fund. Furthermore, the analysis shows that only two agencies, the Department of Economic Security and the Department of Education, provide for the full payment

---

(1) According to the Fund's Training and Education Administrator, the Fund discovered in late October or November 1988 that the same individual obtained a refund from the University for an earlier course the Fund had paid for. The Fund Manager, however, stated in November that the Fund is taking action on this matter.

(2) The Fund is not included in this analysis. According to DOA, the Fund was asked to provide information regarding its tuition reimbursement policy, but failed to respond.

of tuition and other school related costs similar to the Fund. The other 22 agencies limit tuition reimbursement to amounts ranging from $100 to $400 per year, or, will pay between 50 and 100 percent of tuition. Most pay only part of or none of other school related costs.

Four agencies require employees to reimburse the agency if the employee leaves employment with the agency within six months to one year after completing reimbursed courses.

RECOMMENDATIONS

Fund management should:

- Ensure compliance with laws regarding real property acquisitions for operating and investment purposes.

- Discontinue the practice of providing employee awards and similar benefits, or, should obtain specific statutory authority for continuing such practices.

- Revise its employee training and education policy to be more consistent with policies used by other State agencies. The Fund should generally operate on a reimbursement basis, and consider establishing limits on benefits.

FINDING VI

THE BOARD OF DIRECTORS MAY NOT EFFECTIVELY REPRESENT POLICYHOLDERS

The composition of the State Compensation Fund Board of Directors limits the Board's effectiveness in representing its policyholders. The Board is responsible for supervising the Fund and Board members are meant to represent the policyholders. However, weaknesses in the appointment process have resulted in inappropriate Board membership. In addition, its three-member size threatens the Board's ability to comply with the Open Meeting Law and may limit its ability to transact business on behalf of the policyholders.

The Board Of Directors Has A Duty To Represent Policyholders

The Board of Directors is the governing body for the Fund. State law requires the Fund Board members to be policyholders, or employees of policyholders, of the Fund. This requirement indicates that Board members should be knowledgeable about the Fund in order to effectively represent policyholders.

Arizona Revised Statute (A.R.S.) §23-981.01.A states that the Fund is under "direct supervision of a Board of Directors which consists of three members appointed by the Governor for terms of three years." Each member "shall be a policyholder or an employee of a policyholder" of the Fund. This statute further authorizes the Board to make or amend rules and regulations for the conduct of the Fund's business and declare the payment of dividends to policyholders.

The statutory language suggests that Board members represent Fund policyholders. By requiring Board members to be policyholders, or employees thereof, the statute is, in essence, requiring them to be

knowledgeable about the Fund. Fund officials also state that as representatives of the policyholders, the Board's primary goal is to operate the Fund in accordance with the laws and in the best interests of the policyholders and their injured workers.

Appointment Process Has Been Weak

Appointment of Fund Board members has been inappropriate and untimely in several instances. Some Board members appointed by the Governor have not met the statutory requirement that they be policyholders while others met the requirement only by purchasing policies at the time of appointment. Furthermore, delays in gubernatorial appointments to the Board have resulted in long periods with only two members, or with some members serving long after the expiration of their terms.

Some appointees did not meet statutory requirements - Although State law requires Board members to be policyholders, or employees of policyholders, some members have not met this mandate. Twelve members have served on the Fund's Board since its inception in 1969. However, Fund records indicate that three of these were not policyholders, or employees of policyholders, at the time of their appointments. According to a Legislative Council opinion, Board members must be policyholders at the time of their appointments.[1]

Several Board members met the eligibility requirements by purchasing policies just prior to their appointments. Fund records indicate that while eight members can be documented as policyholders, or employees thereof,[2] three became policyholders between 7 and 30 days prior to their official appointments.[3]

---

(1) The Legislative Council opinion also states that members must remain Fund policyholders, or employees of policyholders, for the entire appointment terms. One member did not maintain his policy with the Fund for more than three years of his five-year tenure. See Appendix I for the complete text of the Legislative Council Opinion.

(2) State Compensation Fund staff were unable to locate documents relating to the policyholder status of one earlier Board member.

(3) All three purchased domestic workers policies. Domestic workers polices are a limited type of policy that covers domestic employees (e.g., housekeepers and gardeners) even if they are employed only a few times per month.

At least two other states require a definite length of time as a policyholder to qualify as a compensation fund board member. California and Utah require that board members be policyholders for a minimum of one year prior to serving.

The Board Is Too Small

The Board of Directors appears to be too small to function effectively. As a three-member Board, it has difficulty complying with Arizona's Open Meeting Law. The Board also has problems obtaining a quorum to transact business. Since the Board needs to be enlarged, the Legislature may wish to consider requiring that the Board represent specific policyholder interests.

Open Meeting Law - The Board's size makes it almost impossible to prevent violations of Arizona's Open Meeting Law. As a State agency which is not exempted from the requirements of the Open Meeting Law, the Fund and its Board must comply with provisions to ensure that public business is transacted openly. The Open Meeting Law establishes specific requirements for meetings of State Boards and commissions. For example, Boards must give at least 24 hours notice for meetings and provide an agenda listing "specific matters to be discussed" at the meeting. According to A.R.S. §38-431.01.A, a meeting is defined as a gathering of a quorum. For a three-member Board such as the Fund's, two members constitute a quorum. Therefore, whenever two Board members discuss a Fund issue, even in a telephone conversation, it may be construed as a "quorum." In the absence of the required 24-hour notice and agenda, such discussions violate Open Meeting Law. For this reason, a three-member Board of Directors is not practical under the provisions of Arizona's Open Meeting Law.

Limited ability to transact business - The Board's size has also limited its ability to transact business. Between 1981 and 1985, at least 15 Board meetings were postponed or cancelled for lack of a quorum; two meetings have been delayed during 1988 for the same reason. One current Board member noted that the Board should be expanded to five members to reduce the likelihood of tie votes when one member is absent. Even if tie votes are avoided, critical decisions may be made by two members. For example, each year between 1984

and 1988 only two members attended meetings where Fund dividends were declared. During 1985 and 1986, and half of 1987, there were only two members serving on the Board.

Policyholder representation - Expanding the Board would alleviate the problems with the Open Meeting Law and the difficulties in transacting business. An expanded Board would also provide the opportunity for greater policyholder representation. All nine competitive State workers' compensation funds that maintain Boards of Directors, have larger Boards than Arizona. Five of the nine have fewer policyholders. (See Table 9).

TABLE 9

NUMBER OF POLICYHOLDERS AND BOARD MEMBERS OF COMPETITIVE STATE FUNDS

State	Number of Policyholders (Approximate)	Number of Board Members	Appointed	Elected	Named In Statute
Arizona	39,000	3	3		
California	233,000	5	5		
Colorado	44,000	6	5		1
Maryland	22,000	7	7		
Michigan	31,000	15		15	
Minnesota	5,000	9	4	3	2
New York	191,000	8	6		2
Oklahoma	14,000	5[a]	3		2
Oregon	46,000	5	5		
Utah	22,000	5	4		1

(a) Three of these five are appointed by a specified State official; two are named State officials or their designees.

Source: Compiled by Auditor General staff from information obtained from the funds in April, 1988.

If the Fund Board is expanded, the Legislature may want to consider amending the Fund's statutes to provide for specific representation on the Board of Directors. Arizona Board members do not appear to be drawn from industries representing a large number of policyholders; current and recent members include a retired bank executive, a retired railroad executive, and the former Manager of the Fund. In contrast, California attempts to recruit four of its five members from particular industries (e.g., agriculture and construction) which are characteristic of large numbers of its insureds. Board members in Michigan represent geographic areas and are also selected from small, medium, and large-sized insured employers to assure adequate representation of the diverse size of business owners.

RECOMMENDATIONS

1. The Legislature should consider amending A.R.S. §23-981.01 to require that persons appointed to the State Compensation Fund Board of Directors be insured by the Fund for a minimum of one year prior to their appointments.

2. The Legislature should consider amending A.R.S. §23-981.01.

   - Increase the size of the Board of Directors to at least five members.

   - Provide for expanded policyholder representation of specified occupations and interests on the Board of Directors.

OTHER PERTINENT INFORMATION

During the audit, we developed other information about the relationship between the Fund Board of Directors and the Investment Committee.

State statutes create two separate bodies, both empowered to make decisions impacting the operations of the Fund. As indicated in Finding VI, A.R.S. §23-981.01 establishes a three-person, Governor-appointed Board of Directors and grants it authority to directly supervise the Fund. Charged with ensuring the overall welfare of the Fund, the Board may establish rules and regulations governing Fund operations. The Board also appoints a Fund Manager to oversee daily operations, and it declares dividends when available.

In addition, A.R.S. §23-985 provides for an Investment Committee to oversee Fund investments. Committee members include the Board of Directors Chair, the Fund Manager, and three persons, appointed by the Governor, knowledgeable in investments and economics. The Committee's duties include establishing investment policy and supervising the Fund's investment activities. Specifically, the Committee, by resolution, may invest Fund surplus and reserves in investments authorized by State law. Internally, Fund investment policy states that investments are comprised of monies reserved for future compensation payments to injured workers or their survivors and to meet Fund business needs. During 1986 and 1987, for example, total investment income averaged approximately 26.4 percent of total Fund income.

According to a Legislative Council opinion (Appendix I), Board powers conflict with those of the Investment Committee. The Investment Committee has complete control over investment decisions regarding the approximately $590 million dollars in surplus and reserves, with no final approval needed by the Board. The Board, however, is ultimately responsible for Fund operations. Surplus, reserves and investment income significantly impact Fund operations.

Despite concerns expressed by some Board members, to date no serious problem has resulted from the existing relationship between the Board and the Investment Committee. The Board of Directors and Investment Committee have overlapping memberships which ensures at least some communication between them.

AREAS FOR FURTHER AUDIT WORK

During the course of the audit, we identified three potential issues that we were unable to pursue because they were beyond the scope of our audit or we lacked sufficient time.

- **Does the Fund maintain excess loss reserves?**

  As of December 31, 1987, the Fund maintained over $512 million dollars in reserves for the future payment of compensation and medical losses which have already occurred. In establishing these reserves, the Fund recognizes that income from investing these monies will be earned and used to pay for some of these losses. The Fund discounts the reserves to reflect a portion of these earnings. The discount rates currently used by the Fund are 3.5 percent for compensation reserves and zero percent for medical reserves. However, discounting reserves at these rates may overstate losses incurred by policyholders and may provide the Fund with a profit margin comparable to private carriers. As a result the Fund may not be complying with A.R.S. §23-983(A) which requires that it be neither more nor less than self-supporting.

  The discounting of loss reserves at a rate which more accurately reflects actual investment earnings is an issue which has been raised at the national level. Congress addressed this issue through the 1986 Tax Reform Act by requiring insurance companies to discount loss reserves for tax purposes at a rate tied to interest earnings of government securities. In the case of the Fund, an analysis by the Fund's consulting actuary indicates that, for example, if the Fund discounted reserves at its actual rate of return on investments for 1987 of 10.5 percent, the Fund could reduce existing reserves by as much as $220 million. The result of such a reduction in reserves would be an equivalent increase in surplus.

Further audit work, including the determination of the most appropriate discounting rates and the impact on policyholder premiums, is needed to determine whether the Fund should increase its discounting of loss reserves to reduce the incurred losses reported against policyholders and comply with statute.

- **Does the Fund utilize adequate procurement policy and procedures?**

Our limited review of the Fund's procurement policy and practices indicates some inadequacies. Although the Fund is exempt from the State procurement code, the Fund has developed its own procurement policy and procedures. However, its policy appears weak in some areas. For example, it does not provide for an appeal process for vendors, or specific requirements for evaluating and selecting bids and proposals, both of which are important standards identified in the State procurement code and governmental purchasing literature.

In addition, the Fund may lack adequate control over procurement practices. During the audit we requested a listing of recent contracts. The Fund's purchasing office was unable to supply a listing for five weeks. The delay resulted mainly because the Fund's purchasing office does not maintain copies of ail contracts and supporting documents and had to ascertain the existence of many contracts by contacting individual units within the organization. Further audit work is needed to determine the adequacy of Fund procurement policies and practices.

- **Are the rehabilitation services provided by the Fund effective?**

The Fund's rehabilitation services may be inadequate. The purpose of rehabilitation is to retrain injured workers to enable them to return to work, which then may reduce compensation costs. However, the Fund has been criticized in recent audit reports as being ineffective in identifying potential rehabilitation cases, and ultimately providing these services. Further audit work is needed to determine whether the Fund's rehabilitation services are effective.

STATE FUND
Workers' COMPENSATION Insurance
STATE OF ARIZONA

ROSE MOFFORD, GOVERNOR
BOARD OF DIRECTORS:
WILLIAM L. FINLEY, CHAIRMAN
GORDON C. INSKEEP, MEMBER
CECIL H. MILLER, JR., MEMBER

3031 NORTH 2ND STREET, PHOENIX, ARIZONA 85012 • (602) 631-2050

AN EQUAL OPPORTUNITY EMPLOYER

December 7, 1988

Mr. Douglas R. Norton
Auditor General
2700 N. Central Ave., Suite 700
Phoenix, AZ 85004

Dear Mr. Norton:

Enclosed is the State Compensation Fund's response to the performance audit on the Fund. The Fund takes considerable exception to much of the report's contents.

At your direction, this response was limited and supporting documentation was not attached. This response represents the combined efforts of the State Compensation Fund board of directors, investment committee and management staff.

STATE COMPENSATION FUND

William L. Finley, Chairman
Board of Directors

James L. Adler, Jr., Chairman
Investment Committee

Jerry N. LeCompte, General Manager

Enclosure

SUMMARY
STATE COMPENSATION FUND RESPONSE

The Fund Is A State Agency Subject To Legislative Control

This is not a finding but a statement of a known fact. The only purpose for its inclusion in the audit is to attempt to build a case for the legislature to confiscate Fund assets. The Fund does not disagree that the legislature has the authority to terminate the Fund but believes that the negative impact of such action on the Arizona workers' compensation program would far outweigh the short term fiscal benefit of taking the Fund's remaining surplus. This course of action assumes that such confiscation of surplus is possible. The Fund believes that this or any attempt to utilize Fund monies for any purpose other than the trust purposes for which they were collected will result in extensive litigation, in which the trust nature of Fund assets will be upheld. There is significant case law in Arizona and other states which would preclude use of Fund monies for other purposes.

The Legislature Should Evaluate The State's Relationship With The State Compensation Fund

The need for the Fund has not changed. The Fund's mission is, and always has been, to provide a ready market for workers' compensation insurance to Arizona employers at the lowest possible cost. The Fund does have a very successful investment program and utilizes the income from that program for the purpose for which it is intended, to lower insurance costs for its policyholders. In raising this issue, the auditors appear more concerned about the welfare of the for-profit private insurers than the welfare of Arizona's employers.

The Fund's exemption from federal income tax is not an advantage, because most private carriers do not pay the tax either. A requirement that the Fund pay an in-lieu tax to the general fund would be discriminatory. The Fund is willing to voluntarily obtain a surety bond to meet the security deposit requirements placed on other carriers. The Fund concurs that it has received subsidy from general fund services, primarily because it is required by statute to use these services. The Fund believes it should not be required or permitted to use these services, even if it were to pay for them, since the private sector cannot similarly use the services even if it too pays for them.

Claims Management Could Be Improved Through Private Sector Procedures

The Fund's claims management is effective and employs those practices common to private carriers and state funds which are best suited to the particular needs of both Fund policyholders and claimants. Case assignment by employer, rather than complexity, has been found most suitable, after experience with both methods. Supervisory review is extensive and will be more extensive in 1989. Investigations are timely and are rated highly by the recipients. Outside medical consultants are used extensively and this use will be expanded in 1989.

The audit's characterization of claims management by two questionably managed DOA claims, out of 15,000 over a period of seven years, is misleading. According to DOA's own actuaries, a savings of 21% of forecast losses was due to Fund claims management.

Access Control And Disaster Recovery Procedures For State Fund Data Processing Are Weak

Access control and disaster recovery procedures are not weak. The Fund has access controls, passwords, operations logs and physical restriction in place. The Fund was in process of developing a formal disaster recovery program prior to and during the audit, and the auditors were aware of this. The Fund did not have such program in the past for the simple reason that it did not have its own computer.

Some Actions Have Not Been Fiscally Responsible

All Fund actions have been fiscally responsible. The Abacus Building was purchased as an investment and was approved as an investment by the Fund's investment committee and board of directors. Fund training expenses have not been extravagant. The expenditures for out-of-state participants were in payment of their services in making presentations at training sessions. Lodging expenses for employees were training expenses and not travel expenses. The items provided to employees were not gifts but recognitions of performance, and were no different than those provided by other organizations, public and private. The Fund's education benefits are not excessive. The practice of paying benefits in full and in advance violates no law and provides benefits to all deserving employees on an equitable and nondiscriminatory basis.

The Board May Not Adequately Represent Policyholders

The Fund agrees with the auditors' findings regarding the board. The Fund does not, however, control board appointments, which are under the Governor's office. The Fund will propose legislation to address this area and other points raised by the auditors. A summary of that legislation is attached to this response.

FINDING I: The State Compensation Fund is a state agency subject to control by the legislature.

STATE FUND RESPONSE

This is not a finding but a statement of a known fact.

The Fund Has ALWAYS Been a State Agency: The Fund believes that the sole purpose of this "finding" is an effort to build a case for a legislative attempt to take Fund assets, on the assumption that since the Fund is a State agency, the assets belong to the State and may be used for general purposes.

The Fund Does Not Believe the Legislature Should Attempt to Alleviate the Fiscal Problems of the State at the Expense of 60% of Arizona's Employers. While the Fund is not legally a mutual insurance company, it operates as a mutual company, so far as these employers are concerned. Since the assets of the Fund are comprised of employer premium payments and the investment earnings on those premium payments, the employers will most assuredly resist any effort to utilize those assets for purposes other than for which they were intended. Any effort to confiscate Fund assets will most assuredly result in extensive litigation.

The Fund Believes That Confiscation of Fund Assets Could Not Be Accomplished Without Litigation and Would Not Be Successful: The audit discusses three methods by which the legislature might have access to Fund assets: 1) termination of the Fund; 2) sale of the Fund; and 3) confiscation of surplus while the Fund is in operation.

The Fund Agrees That the Legislature Has the Authority to Terminate the Fund If It So Desires: The Fund also believes, however, that the scope of such action goes far beyond the aspect of distribution of Fund assets and would be detrimental to the employers of the state, their workers and the general public as a whole, and also would totally undermine one of the nation's most stable workers' compensation systems.

A.R.S. 23-1029.B does state that Fund assets are subject to legislative disposal in the event the Fund is terminated. Even so, the auditors are cautious in interpreting this statute on a literal basis, and suggest that further research is required to determine if this provision is legal. The Fund concurs with the auditors' caution and believes that the statute as written did not contemplate or recognize the source, purpose and trust nature of Fund assets.

Sale of the Fund Would Probably Be Illegal: The auditors essentially dismiss the sale of the Fund as a viable alternative, citing no precedent in law for such sale, and Arizona case law which defines the Fund as a private trust fund. The Fund concurs with this conclusion.

There Is More Legal Precedent Against Confiscation of Fund Surplus Than In Support of Such Action: The audit discusses at length the confiscation of Fund surplus while the Fund continues in operation, and cites as support for such action the State's liability for Fund losses under A.R.S. 23-981.C, and two instances wherein surplus of other state funds was confiscated. The auditors mention but tend to discount two other instances wherein such efforts were unsuccessful, as well as two case law decisions by the Arizona Supreme Court

and a formal opinion of the Arizona Attorney General which would preclude the confiscation of any Fund assets.

The State Should Have No Liability For Fund Losses: The pertinent provisions of A.R.S. 23-981.C should have been repealed when the Fund separated from the Industrial Commission in 1969. This law was a carry-over from the time when the State was the actual insurer, through its Industrial Commission, and therefore should have been responsible for losses. This provision was intended to be a guarantee of losses by the State, and never was intended to give the State access to Fund assets. The provision should now be repealed, and the Fund will include such repeal in its proposed legislation (See Appendix I).

Court Decisions in Oklahoma and Utah Should Not Be Discounted: The auditors discount these decisions which ruled against confiscation of surplus, on the presumption that the basis of these decisions was that those states had no liability for state fund losses. It is the belief of the State Fund that these decisions were based upon the trust nature of the funds.

The Purpose For Which Fund Revenues Are Collected Has Not Changed: The Arizona Supreme Court, in Sims v. Moeur and Industrial Commission v. School District No. 48, held that the Fund was a trust fund....for the use and benefit of employees and employers/policyholders. The auditors discount these rulings on basis that they are nearly 50 years old. These rulings are, in fact, just as applicable as they were when rendered, because the purpose for which the monies are collected is exactly the same as it was 50 years ago.

Attorney General Opinion 179-091 (R78-340) Should Not Be Discounted: The auditors tend to discount this 1979 opinion, on basis that it addresses what they define as a much narrower issue of tax revenue. The auditors ignore the key finding of the attorney general who, citing the aforementioned Supreme Court decisions and the above referenced Oklahoma decision, opined that the revenues of the Fund are a trust fund and "are not for the state's own use".

The Fund Does Not Have Excess Surplus or Excess Reserve: The auditors make reference to "excess surplus" and "excess reserves", and elaborate on this topic in a concluding section entitled "Areas Further Audit Work". The auditors' comments reflect a lack of understanding of the rate making process, the fiscal solvency requirements of an insurance carrier and the principles of insurance in general. The Fund explained to the auditors, more than once, that an increase in the Fund's reserve discount factor would have no impact on incurred losses reported against policyholders, since the rating bureau mandates the discount to be used in reporting losses.

The Auditors' Statements Are Contradictory: The auditors imply that the Fund is required to maintain only $750,000 in surplus, yet, in a contradictory statement, appear to suggest that the Fund could increase its surplus by millions of dollars by increasing its discount rate. It is a fact that either of these courses of action could ultimately have serious impact on the solvency of the Fund.

The Auditors' Suggestions And Comments Are Contrary To The Intent of 1983 Law Changes: The auditors appear to suggest that since the State is responsible for Fund losses, the Fund should not be subject to the same solvency requirements as a private insurer. In the opinion of the Fund, this logic makes

no sense and conflicts with 1983 law changes which brought the Fund under the provisions of title 20 and the rules of the director of insurance to the same extent as any private insurer. It is the director of insurance who therefore should ascertain the appropriateness of the levels of Fund deposits, reserves and surplus, and not the auditor general's office.

FINDING II: The legislature should evaluate Arizona's relationship with the State Compensation Fund.

STATE FUND RESPONSE

The audit makes a number of incorrect statements and assumptions.

The Role of the Fund Has Not Changed: The auditors refer to the Fund's original role as a "source of last resort". This implies that employers only came to the Fund if they could not obtain coverage elsewhere, which is untrue. The Fund was required to write any employer who requested coverage, but there was no requirement that the employer first apply with a private insurer.

The audit states that "due to changes over time", the Fund is now Arizona's leading writer of workers' compensation insurance. The Fund in fact has always been the leading writer because it has always met its purpose and mission, which is to provide a ready market for workers' compensation insurance to Arizona's employers at the lowest possible cost.

The Need for the Fund is Greater Than Ever: The audit infers that since there are now over 100 companies who write workers' compensation insurance and there also is an assigned risk plan, there may be no need for the Fund. In fact, the events which have taken place in the Arizona market in recent years suggest that there is more need than ever for the Fund. The private insurers have reduced their writings or have withdrawn from the market entirely, and the Fund has fulfilled its role, by providing insurance to those employers whose coverage was cancelled by the private companies. Most, if not all, of these employers would have been forced into the assigned risk plan, if the Fund had not existed.

The Assigned Risk Plan is not an Alternate Source: The auditors appear to portray the plan as simply an alternative source of insurance. It is in fact a penalty program, wherein employers pay a surcharge of 20% over filed rates and are ineligible for any dividends or deviations. Its intended purpose is to provide a final source of coverage to a limited group of employers who either refuse to make any effort to control losses or who represent an unknown risk which could severely impact the financial condition of any carrier who insured them.

It is notable that when the assigned risk plan was created in 1969, the legislature in its wisdom made it a requirement that an employer could not be placed in the plan unless the Fund declined coverage. This wisdom and the Fund's continued fulfillment of its mission to provide a ready market are clearly illustrated by the fact that Arizona's assigned risk plan is the lowest in the nation, in terms of the percentage of employers in the plan. Arizona's 1% contrasts with 30, 40 or 50% or more in states where private insurers have an exclusive market.

The Fund Does Represent Small Policyholders: The audit infers that the Fund does not represent a disproportionate share of small policies. Since the auditors refused the Fund's request for the data used to reach this conclusion, the Fund was unable to verify the accuracy of the information. The Fund did follow up with the source of the data, the NCCI and determined that the auditors did not properly interpret that data. Therefore, the auditors' numbers are incorrect and their conclusions probably wrong.

Perceived Advantages Enjoyed by the Fund

Investment Income is an Advantage...To the Fund's Insured Employers: It is true that the Fund does maintain a very successful investment program and does utilize investment earnings to reduce costs to its policyholders. The auditors appear to be saying that this is wrong, and the Fund should not be able to do this. The Fund disputes this contention. In fulfilling its mission of providing a mandatory social insurance at the lowest possible cost, the Fund believes it to be quite proper to utilize investment earnings to reduce employer costs.

As to the contention that investment income provides a competitive advantage to the Fund, the Fund believes that the auditors overlook the fact that it is the employers who insure with the Fund who benefit from this income. The Fund is disappointed that the auditors, who are the appointed guardians of the public interest, appear to be more concerned with the welfare of the for-profit private insurers than the cost of workers' compensation insurance to Arizona's employers.

Exemption from Federal Income Tax is Not an Advantage: The auditors assume that private insurers pay income tax, and few if any do. Private insurers structure their portfolios and accounting records to pay little or no tax. The report does note that 1988 would have been the first year the Fund would have owed any tax, so there has not been even a perceived advantage prior to 1988.

Payment to the General Fund in Lieu of Federal Tax Would be Discriminatory: First of all, this would represent just one more effort to alleviate the financial woes of the general fund at the expense of 60% of Arizona's employers. In addition, unless private insurers also pay this tax, it would be discriminatory against the Fund, since private insurers can legally avoid paying federal tax.

The Fund is Willing to Meet the Security Deposit Requirements of A.R.S. 23-961.C: The Fund is in the process of obtaining quotations for a surety bond and intends to post such bond to voluntarily comply with the statute. This will serve two purposes: to eliminate any perceived advantage for the Fund over private insurers and significantly reduce any liability the State may have for Fund losses. In addition the Fund will include in its proposed legislation a change to A.R.S. 23-961.C, to reflect that the statute does apply to the Fund. This will compliment the proposed change to A.R.S. 23-981.C, as discussed in Finding I, which will remove all liability for Fund losses from the State. (See Appendix I).

The Fund Agrees that It Should Receive No Subsidies From General Fund-Supported Functions: The Fund agrees that it has utilized the services of general fund-supported activities. With the exception of state purchasing contracts, the Fund has been required by statute to use these services. Although the Fund is exempt from the state purchasing, it has used state contracts and has offered to pay for such use, but never has been billed.

The Fund Should Not Be Required or Permitted to Use Any General Fund-Supported Function: The recommendation that the Fund continue to use and pay for State-subsidized services will not eliminate the Fund's perceived advantages over the private insurers, because private insurers cannot use these services even if they pay for them. The Fund should be required to purchase these services on the open market, the same as private insurers. In 1983, the Fund supported legislation which eliminated some, but not all, statutorily mandated services that the Fund had been receiving. The Fund will propose legislation to eliminate all remaining subsidies (See Appendix I).

The Fund Should Continue to Serve the People of the State of Arizona: The audit concludes discussion on this finding with arguments for and against continuing the Fund. In the opinion of the Fund, the arguments against continuing the Fund are not valid, because they are based upon assumptions and conclusions which are not true. The arguments presented for continuing the Fund are valid, but do not include certain equally, if not more, important reasons.

Workers' compensation is a mandated social insurance and the oldest form of no fault insurance. Its purpose is to protect and benefit employers, their injured workers and, ultimately, the general public as a whole. It should therefore be readily available at the lowest possible cost, and that is the role of a state compensation fund. Twenty states have shown the wisdom of their legislators by creating state funds, including two new funds in this decade. These twenty states have the most stable workers' compensation systems in the country. Other states such as Maine, New Mexico, Texas, Louisiana and Florida are seriously studying the creation of new state funds in effort to bring order to their chaotic workers' compensation systems.

The national direction and trend is to more state funds, not less. There is no valid reason for Arizona to take a backward step and wreak havoc on one of the nation's most stable workers' compensation systems, by making it the exclusive domain of the for-profit private insurance sector.

FINDING III: The State Compensation Fund can significantly improve its claims management by adopting procedures used by the private sector.

STATE FUND RESPONSE

The auditors infer that Claims Management is deficient in four areas: (1) case assignment, (2) supervisory review, (3) investigation and (4) medical management. The Fund disagrees in all four areas. The audit supports its findings with DOA's experience. The Fund disagrees with the relevance and conclusions of that experience.

Fund Case Assignments Are in Accordance With Industry Practices and Result From Experience Under Both Systems: Although the audit agrees the Fund method of case assignment does establish good rapport with policyholders, it recommends assignment based on complexity. However, the Fund has had direct experience with the assignment of cases based on complexity. It was the Fund's experience that the loss of good policyholder coordination offset the advantages of complexity assignments.

The audit relies on four unidentified workers' compensation carriers who allegedly assign on complexity. However, the Fund's survey of ten workers' compensation carriers found the following: Nine carriers assigned cases by policyholder in the same manner as the Fund, and one used claimant's location. None assigned cases as suggested by the audit. One had assigned on the complexity basis and returned to the policyholder method for the same reasons.

Supervisory Review at the Fund is Not Limited, is Extensive and Will Become More Extensive on 1/1/89: The audit finds supervisory review of Fund claims to be limited compared with five anonymous companies. The Fund maintains that its supervisory review is not limited and is in excess of that performed by those companies. The companies have only two or three criteria for supervisory review. In contrast, the Fund has thirteen, reflecting a much broader range of supervisory review and input to the claim management function. All reviews are verified by an internal auditing function.

The Fund's Investigation Practices Are Not Infrequent, Inadequate, Usually Late or Out of Line With Industry Standards: The audit finds claims inadequately investigated, results "usually" late, and investigation practices to be in contrast with the insurance industry. The Fund conducts formal investigations where necessary. Since it is generally accepted that only 5% of reported claims are invalid, the investigation of 18% of all claims is not inadequate. A claims specialist having 26 years experience in workers' compensation with seven carriers maintains one-sixth of claims need formal investigation. This is 17%, which is comparable to the 18% formally investigated by the Fund. Other state funds conduct investigations on the same percentage of cases as does the Arizona Fund.

The Fund maintains a quality control system using data from the requestor of each investigation. The system shows 94% were rated as excellent or good, 6% were rated as fair, and 0% were rated as bad. Of the total, only 11% were late, most being the result of backlogs not related to the investigation. Fund disagrees reports are "usually" late. The audit's note that denial of a claim pending completion of an investigation is an unfair claims practice is wrong. Only "unreasonably" denying a claim without supporting information is unfair. R4-13-163.C.1.

The Fund's Medical Management is Not Inadequate: The audit finds that in 18% of sampled files medical histories were sought. The Fund does not consider this to be inadequate. In the first place, adequate medical histories may already be available in the file, thus obviating the need to solicit additional history. Second, only 20% of the claims are of the more serious time-lost variety in which more extensive medical work-up is required. The solicitation of additional medical history in 18% of cases, knowing that other medical history may already be present in the file, and realizing that only 20% of cases involve serious claims that may require additional medical history, is not inadequate.

The Fund does make adequate use of independent medical examinations and does obtain extensive second opinions. The Fund utilizes approximately 6,000 independent medical examinations per year, over and above the medical examinations being conducted by the attending physicians. In light of the fact that approximately 12,000 claims are serious time-lost cases per year, the use of 6,000 second opinions for the management of those claims is not inadequate.

The audit finds the Fund does not employ medical professionals to assist in medical management. This is not correct. The Fund has chosen to obtain this expertise through outside sources, including a utilization review organization staffed by medical professionals who carry persuasive weight in managing claims already subjected to medical providers. In addition, the Fund is now negotiating with a national organization for assistance in the medical management of back injuries. That organization will enhance the already strong effort of the Fund to alter the medical direction of appropriate claims.

The audits' criticism on limited use of rehabilitation nurses is inappropriate. The November 1988 Research Brief of the Workers' Compensation Research Institute found **no improvement** in outcomes by even early intervention with rehabilitation nurses. Both compensation and medical benefits were actually **greater** in the claims with rehabilitation nurse intervention.

The DOA Experience is Not a Valid Basis For a Performance Audit of the Fund's Entire Claims Management Operation: The audit of Fund claims is little more than a recitation of prior audits by DOA through its "independent consultant."

It is curious that the audit forecast claims payments to be $8.6 million but that only $6.8 million were paid by the Fund. Although this would seem to be a cause for **praise** of Fund claims management, it becomes a cause for **criticism**, on the basis that only by DOA intervention was the Fund able to manage the claims better than expected. In contrast, consulting actuaries employed by DOA, Milliman & Robertson, Inc., explained the favorable claims experience in quite another manner: "First, we believe the current favorable experience is largely due to the cost containment programs implemented by the State Fund ...". **Nowhere** in the actuaries' report to DOA is found the conclusion that the State's favorable claims experience is due to the Risk Management Division's supervision of the Fund's processing of State claims.

The audit's use of three cases from DOA experience are noted to have occurred over a period of seven years. The Fund submits that **three cases out of approximately 15,000** cases processed for DOA over the last seven years is not a representative sample by which to judge the Fund's claims effort. In addition, Case I reflects DOA's simplistic employer's concept of Workers' Compensation Law. DOA advises the claim is invalid because it doesn't meet all the requirements of ARS 23-1043. That is **not** the law. The law is that "strict satisfaction of all special compensability requirements is unnecessary to be entitled to compensation." Superstition Const. v. ICA, 139 Ariz. 337 (1984). That case further holds the ultimate factor is whether the hernia is causally related to the industrial accident. Also, cases II and III have extenuating circumstances not mentioned by DOA.

Finally, the audit totally ignores the obligation of claims management that "in workers' compensation proceedings, the objective is to have industry fully bear its share of human injury as a cost of doing business, and compensation law is liberally construed to achieve that objective." Unigard Mut. Ins. Co. v. Martin, 134 Ariz. 144 (1982). In this regard an Industrial Commission official advised the Fund has a disproportionately small number of unfair claims processing allegations, compared to carriers in the private sector which the audit recommends the Fund emulate.

FINDING IV: Significant weaknesses exist in access control and disaster recovery procedures of the Fund's computer systems, increasing the risk of fraud or abuse.

STATE FUND RESPONSE

There is no question that the Fund is dependent on modern electronic data processing and has been a pioneer in the development of this capability since its inception in 1969. The Fund's current systems are used by many companies, including private insurance carriers, as a model of the 'ideal' information network.

Access Controls and Physical Security Are Not Weak: While the controls of any electronic data processing operation can be strengthened, the access controls and physical security at the Fund are not weak. As systems evolve and conditions change, these controls are continuously reviewed and strengthened where the change is determined to be cost effective.

Access Controls: Contrary to the audit finding, the Fund does protect against unauthorized access to computer data through the use of passwords that are assigned and changed randomly. Predefined keys are used in a limited area and do not allow general unfettered access to computer data. None of these keys will allow the using individual to submit jobs for execution or the alteration of the current file information, unless authorized and cleared through a separate operations screening process.

Reports of terminal activity are reviewed (contrary to the audit report) by EDP management and, where applicable, operating department management to determine uses of any specific terminal in terms of context, time and frequency.

The finding indicated a general lack of control on the access to the claims file. On the contrary, all changes are automatically logged onto a transactions file that provides recovery and tracking capabilities. We can always determine what change was made, when it was made, and who made the change. Access to these designed update screens is limited to certain times of the day and from specific terminals. Other automated systems detect duplicate payment requests by application. We believe that the Fund has significant controls in place that deal with deterrence and detection.

Physical Security: Contrary to the finding, the Fund does not provide unlimited access to vital computer operations and programs. In fact, the access door has a magnetic card system with these cards being issued to authorized personnel, and a log of all usage of this system is reviewed on a regular basis. Authorized personnel does not include all Fund programmers. The access to written program documentation was reported to be not adequately restricted. We disagree on the risk identified but continue to monitor this and every access to programs or documentation in the future for appropriate change.

Disaster Recovery Controls Are Not Inadequate: It was almost refreshing to note a consideration of current efforts in the audit review. This planning is well underway (as noted in the limited reference in the finding). Moreover, the Fund has many disaster recovery items already available that were ignored in the finding, including off site storage of master files, documentation, controls, historical reports, hard copy and micrographics information and the ability to

operate from several (or all) of the various district offices of the Fund throughout the state.

FINDING V: The Fund has not been fiscally responsible in some areas.

STATE FUND RESPONSE

The Fund disagrees with this finding for the following reasons:

The Fund Has Complied With Statutory Requirements During Building Purchases: The purchase of the Abacus building was approved by the board of directors and, subsequently, by the investment committee. This information was documented in the minutes of the investment meeting held September 19, 1986, about one month prior to the building purchase. It was further documented in a letter from Mr. James Adler, chairman of the investment committee, to the Auditor General.

No Formal Investment Resolution is Required: The chairman of the board of directors and the manager of the Fund both serve on the investment committee. This committee was completely informed as to the need for additional office space and the investment potential of the purchase of the Abacus building by the Fund. As stated previously, the committee approved that purchase, as documented in the minutes of the meeting held on September 19, 1986.

The committee determined that no changes were necessary in the internal investment policy because such investments were seen as rare events. Contrary to the finding, income from real estate is included as investment income on statutory reports. It is the opinion of the Fund's legal counsel that minutes of meetings in which decisions are made are sufficient documentation to meet the requirement for an investment resolution. In addition, a specific resolution referencing the decisions of the board of directors and the investment committee was produced in a timely fashion.

Finally, the board of directors or the investment committee has the statutory authority to purchase buildings as investments, according to A.R.S. 20-534.

Employee Awards and Training and Education Benefits Are Not Excessive: The major training event is designed to: 1) update staff on Fund operations, 2) foster communication among its professional staff, 3) train and motivate staff, and 4) recognize top employee performance. Such events are common for private businesses and state agencies.

Officials from neighboring state funds are invited to attend and make presentations on the subject of workers compensation to provide training for all personnel attending the meeting. These invitees travel at their own expense. Food and lodging is provided in exchange for their presentations. When the facts are shown, this function is a bargain.

Recognition of performance by memo, letter of congratulation, engraved plaque, watch or briefcase are commonplace throughout the business world, and state government. These items are not gifts but are all related to the performance of their duties, and are more practical than a plaque. The motivational effects of performance recognition, documented by continued outstanding performance by

many of these same employees (and others), make these expenditures not only a bargain, but a necessity.

All expenditures involved in the Institute and other related programs are training costs and are not subject to the per diem travel limitations. Moreover, they are part of the training budget approved by the board of directors, reviewed by JLBC analysts, and approved by the JLBC. These expenditures are not out of line or excessive.

Education Benefits Are Not Excessive: The finding contends that the Fund allows 'generous' education benefits to its employees, while stating that the Department of Economic Security and Department of Education provide the **same** level of benefit. The Fund is criticized for paying costs in advance where other agencies reimburse after the fact. Paying tuition costs 'in advance' rather than as a 'reimbursement' indicates a commitment of Fund management to the program. More importantly, it provides an even handed, less discriminatory method to allow all qualified employees access to this program. It is surprising the other state agencies continue to use a system that could be considered discriminatory. Not every employee is financially able to pay the up front costs of tuition and books, even when reimbursed later. Should they be denied the opportunity?

The Fund does require a minimum passing grade (C), a direct application of the program to the workplace and other qualifications for approval of an employee to be eligible for education benefits. In addition, the Fund will recover these costs if an employee does not meet the minimum performance level. The program is designed to provide the maximum return for the expenditure, keeping in mind that even 'passive' discrimination has no place in Fund management policies.

The auditors isolated on one employee for whom it was stated that $11,000 was paid over a specified period of time, after which the employee left the Fund. What was overlooked and not reported was the fact that a portion of this money represented payment in advance of several courses to negate the impact of announced increases in tuition. Also overlooked was the fact that when the employee left, the Fund was reimbursed by the program for courses not yet taken. In addition the Fund is in process of recovering additional sums directly from the employee.

Fund management knows that it is not possible to 'out bid' private employers for employees in the marketplace. The only long term solution is to provide the opportunity for training, education, performance planning, evaluation and recognition for a job done well. Again, these expenditures are not excessive or improper.

General Comment: There are contradictory positions taken by the auditors in certain areas of their report. In some areas, critical findings and recommendations were developed based upon comparing the Fund to similar funds in other states, or by comparing the Fund to private insurance companies.

In the case of training expenses and tuition reimbursements, the intent is to compare the Fund to other state agencies, despite the fact that the mission of these agencies may be totally opposite that of the Fund. The fact that the Fund's competition (private insurance companies) not only pay educational and

training benefits far beyond the level found in the Fund, but also financially reward the completion of many of these programs, was ignored in the review.

The auditors seem to be suggesting that the Fund should operate like other state funds or like private insurance companies or like a state agency. If nothing else, these moving comparisons illustrate the challenges the Fund faces in attempting to operate as a business, in a competitive business environment, while also attempting to meet all the statutory requirements of being a state agency.

FINDING VI: The board of directors may not effectively represent the policyholders.

STATE FUND RESPONSE

The auditors' observations regarding the present appointment process are valid; however the State Fund has no control over the process. Board members are appointed directly by the governor without input from, or consensus of, the State Fund. The Fund's only role is to assist appointees in fulfilling the letter of the law by obtaining a policy after being appointed. Likewise, the Fund has no control over un-filled vacancies other than to periodically contact the governor's office and urge that vacancies be filled. It is necessary for members whose terms have expired to continue to serve, if they are willing to do so, in order meet quorum requirements. The legislative council opinion which was a part of the audit report indicates agreement with this situation.

Minimum Requirements for Appointment: The Fund has no objections to a requirement that appointees shall have been policyholders or employees thereof for a minimum amount of time prior to appointment. However, such a requirement would increase the difficulty in filling such appointments by requiring that a candidate be currently active in business as an owner or employee. Based upon past experience, these individuals have the most difficulty in taking time away from their business to attend meetings, particularly when they are paid the very nominal sum of fifty dollars per day. As a result, the Fund will recommend in proposed legislation that the daily compensation for board members be increased significantly to compensate for this probable impact (see Appendix I).

Increase in the Size of the Board: The Fund supports the auditors' recommendation to increase the board membership from three to five members. This change would bring the board to a size which is more representative of the policyholder base and would make it easier to meet open meeting and quorum requirements. The Fund will include this change in its proposed legislation (see Appendix I).

Industry or Occupational Representation on the Board: The Fund does not support the appointment of board members to represent specific industries or occupations. This recommendation would lead to polarization of the board along special interest lines and would impair the board's ability to serve the best interests of all policyholders. The State Fund is not aware of any benefits which are achieved by such specialization, even in the exclusive state funds where it presently exists.

In addition to the aforementioned changes which the State Fund will include in its proposed legislation, the Fund also will propose that the terms of board members be increased to five years and staggered to provide for the expiration of one term each year.

Other Pertinent Information: The relationship between the board of directors and investment committee was examined by the auditors, and in the Other Pertinent Information area of the report indicates a possible conflict with the authority of these two appointed groups. To resolve this possible statutory conflict, the Fund will support further change by proposed legislation concerning the board/committee relationship (see Appendix I). In addition to endorsing the recommended change from three to five board members, the Fund agrees that the board has the ultimate responsibility for Fund operations, a portion of which is the effectiveness of the investment program. It is further clear that the board should determine overall administrative policy, including investment guidelines, and the functions of the investment committee can readily (with the expanded board members) be a responsibility of the board. In short, with this change, the investment committee would not be necessary. The outside investment advisory services, director of investments position (and staff as needed), custodial bank services and any other necessary functions would be the responsibility of the fund manager, under overall direction of the board.

APPENDIX I

PROPOSED LEGISLATION

The State Compensation Fund (Fund) is Arizona's leading workers' compensation insurance carrier and is in direct competition with more than 100 private insurance companies. It is appropriate that the Fund be on a level playing field with that of its private competitors. In order to accomplish that goal, all actual or perceived advantages that the Fund, as a state agency, may have over its competitors need to be eliminated. Such changes have been made in the past few years in the states of Oregon, Colorado, Minnesota and Utah. These proposed legislative changes will bring about a fair and equitable level of competition between the Fund and its private insurance competitors.

23-981. State compensation fund; purpose; composition; administration; powers and duties

A. [No change]

B. [No change]

C. A manager shall administer the state compensation fund, subject to the authority of the board of directors, without liability of the state. ~~beyond payment of losses sustained on account of the fund.~~[1] The fund shall be applied to insurance and to payment of compensation and expenses as provided in this chapter. The manager has full authority over the fund and may do all things necessary or convenient in the administration of the fund, or in connection with the compensation business to be carried on by ~~him~~ <u>the manager</u>[2] under this chapter, and may adopt rules and regulations for collection, maintenance and disbursement of the fund and perform all other functions which the laws of this state specifically authorize or which are necessary or appropriate to carry out the functions so authorized.

D. [No change]

E. The operating and capital outlay budget of the state compensation fund shall be prepared on a calendar year basis and submitted for review and approval by the [~~joint legislative budget committee~~] <u>board of directors</u>[3] on or before October 1 preceding the budget year.

23-981.01. Board of directors of state compensation fund; manager of state compensation fund; appointment and powers

A. The state compensation fund shall be under the direct supervision of a board of directors which consists of [~~three~~] <u>five</u> members appointed by the governor for <u>staggered</u> terms of [~~three~~] <u>five</u> years. Each member shall be a policyholder or an employee of a policyholder of the state compensation fund. Appointment to fill a vacancy caused other than by expiration of a term is for the unexpired portion of the term. <u>The term of office of the directors shall begin January 8 of the year of appointment. Of the directors appointed to the board with terms beginning January 8, 1990, one shall be appointed to a term ending January 7, 1993, one appointed to a term ending January 7, 1994, and one appointed to a term ending January 7, 1995.</u>[4] Each member of the board is entitled to receive as compensation [~~fifty~~] <u>three hundred</u>[5] dollars per day while in actual attendance at meetings of the board and shall be reimbursed for mileage and subsistence as allowed by law in traveling from his regular place of residence to meetings of the board, or to the place where he discharges his duties, with the compensation and expenses paid out of the state compensation fund. The [~~governor~~] <u>board</u>[6] shall annually appoint the chairman from among the members of the board. The board may make rules and regulations not

inconsistent with law, as it deems proper for the conduct of its business and, by resolution, may declare the payment of dividends to policyholders from the surplus of the state compensation fund. The board may amend or change the rules and regulations and may cause them to be published and distributed.

B. The board of directors of the state compensation fund shall appoint a manager of the state compensation fund, who has charge of the daily operation of the state compensation fund. The manager shall have proven successful experience as an insurance executive at the general management level. The manager is entitled to receive compensation as determined [~~pursuant to 38-6711~~] by the board,[7] and may be removed only for cause by the board. The manager has such powers as are necessary to carry out the functions of the state compensation fund and shall include:

1. The formulation and administration of a system of personnel administration and employee compensation that utilizes merit principles of personnel management and includes employee benefits and grievance procedures.[8]

2. The formulation and administration of an investment policy and supervision of the investment activities of the state compensation fund. The manager may invest and reinvest the surplus or reserves of the state compensation fund in any legal investments authorized under Title 20, Chapter 3, Article 2.[9]

C. The state compensation fund is exempt from the provisions of title 41, chapter 1, article 5.

23-982. ~~Custodian of funds; duties;~~ Audit of fund

A. ~~The state treasurer shall be custodian of the state compensation fund, and all disbursements from the fund other than investments authorized under 23-985 shall be paid by him upon vouchers authorized by the manager. The treasurer, with the consent of the manager, shall deposit any portion of the fund not needed for immediate use as inactive state funds are deposited, and the best interest obtainable shall be collected upon such deposits and placed to the credit of the compensation fund.~~[10]

~~B. All monies collected by the compensation fund shall be forthwith paid to the state treasurer.~~

~~C.~~ Commencing with the year 1970 and each year thereafter, or more often if ~~he deems~~ deemed necessary, the manager of the state compensation fund shall cause an audit of its books of accounts, funds, and securities of the state compensation fund to be made by a competent and independent firm of certified public accounts, the cost of the audit to be a charge against the state compensation fund. A copy of the audit report shall be filed in the office of the secretary of state and a copy shall also be filed with the insurance department, and twenty copies shall be filed with the manager of the compensation fund. Such audit shall be open to the public for inspection.

23-985. Investment committee; powers and duties; counsel; report[11]

23-986. Applicability of title 20 to fund; exemption of other statutory provisions; insufficient assets; insurance director duties

A. [No change]
B. [No change]
C. [No change]
D. [No change]

E. The operations, transactions and affairs of the state compensation fund are exempt from the following provisions:

1. Title 35.
2. Title 39, chapter 1, article 1.
3. Title 41, chapter 4. ~~articles 3 and 7.~~[12]
4. Title 41, chapter 8, article 3.
5. Title 41, chapter 3.1.[13]
6. Title 38, Chapter 4.[14]

Footnotes

[1] A.R.S. 23-981.C. is changed to absolve the State of Arizona of liability for Fund losses. The carriers which the Fund competes with do not have the benefit of such a safety net, and there is no valid reason why the Fund should have that benefit. In 1983 legislation was passed placing the operations of the Fund under the statutes governing insurance operations, Title 20. In addition, Title 23 provides a guarantee fund for the payment of benefits by all carriers through the Industrial Commission. It is neither necessary, nor fair for the Fund to continue to have this state benefit.

[2] A.R.S. 23-981.C. refers to the manager of the Fund in the masculine gender. The reference in this section to a masculine manager has been deleted.

[3] A.R.S. 23-981.E. requires approval of the Fund budget by the Joint Legislative Budget Committee. This will be changed to require approval of that budget by the board of directors of the state fund. Consideration of such a budget by the legislature is an unnecessary expense to the state and this budget does not contain expenditures of state revenues. The Fund and all other insurance operations are regulated by the Arizona Department of Insurance and, therefore, it is unnecessary for the state to be taking responsibility for budget matters which are not part of state appropriations.

[4] A.R.S. 23-981.01.A. is changed to increase the members of the board of directors from three to five. This brings the Fund into conformity with most other state compensation funds and makes it easier to comply with open meeting laws, which require a quorum to conduct business. This change has been recommended by the Office of the Auditor General in its recently completed performance audit. This section also requires staggered terms of five years. The terms will be staggered for better continuity, and the term of office must then be increased to five years to keep the staggered membership at full strength.

[5] The compensation of the board members is increased from $50.00 per meeting to $300.00 per meeting. This change is necessary to attract candidates on a competitive basis with boards of directors of private enterprises which may compete for the same members. Although $50.00 per day may be adequate compensation for members of governmental boards, the Fund will be competing with other commercial operations such as insurance companies for its board members. The $300.00 per day compensation is also consistent with that paid by other quasi-governmental organizations.

[6] This section deletes the appointment of a chairperson by the governor and leaves that appointment to the board itself. Since the board of directors is appointed by the governor, the selection of a chairperson by the board is indirectly an appointment by the governor.

[7] A.R.S. 23-981.01.B. is changed to permit the manager's salary to be set by the Fund's board of directors rather than by the State of Arizona, Department of Administration. This change would provide the Fund's board of directors greater flexibility to hire the best qualified person for the position of manager and would eliminate a state subsidy received by the Fund in the form of services rendered to perform this function by the state's personnel division with a general fund expenditure.

[8] A.R.S. 23-981.01.B. is also amended to provide that the Fund administer its own personnel system. Presently, as a state agency, the Fund's employees are under the jurisdiction of the state personnel system in all respects. Since the Fund's personnel system is being administered by the state personnel system by State of Arizona employees at the expense of the general fund, the Fund is receiving a subsidy from the state which is not available to competing workers' compensation insurance carriers. Fund employees will remain part of the Arizona State Retirement System without subsidy from the general fund. This change is consistent with the recommendations of the Auditor General.

[9] A.R.S. 23-981.01.B. is also amended to resolve a statutory conflict between the responsibilities of the board of directors and the investment committee. The board of directors has the overall responsibility for the operation and results of the Fund; however, the board has no authority or control over the investment committee or the investments made by that committee. A survey of other state funds reveals that the Arizona Fund is the only one which has an investment committee. The statutory conflict is resolved by the repeal of A.R.S. 23-985, which provides for the investment committee, and the overall responsibility for the investment program being placed under the manager with direction from the board. This change is also consistent with the recommendations of the Auditor General.

[10] A.R.S. 23-982 mandates that the state treasurer serve as the Fund's banker. All services of the treasurer's office are provided without charge to the Fund and, as a result, constitute a subsidy to the Fund which is not available to the Fund's competitors. This legislative change will eliminate this subsidy and the Fund will seek its own banking services. This change is consistent with the recommendations of the Auditor General.

[11] [Entire statute to be repealed] (See Footnote No. 9.)

[12] A.R.S. 23-986.E.3. is changed to exempt the Fund from the Arizona Department of Administration and Personnel Board. The Fund is presently exempt from the finance and property management provisions of article 41. This change would eliminate a subsidy received by the Fund for personnel services (article 5). The Fund is presently self-sufficient in its automation functions. Accordingly, the Fund should be exempt from article 2 (automation functions) and article 8 (mobile home parks hearing officer function). This change is consistent with the recommendations of the Auditor General.

[13] A.R.S. 23-9086.E.5 is added to exempt the Fund from the State's risk management provisions. The Fund has been required to participate in the State's risk management program for its insurance coverage. The Fund is being subsidized by this State program - a program not accessible to the fund's competing carriers. This change is consistent with the recommendations of the Auditor General.

[14] A.R.S. 23-986.E.6. is added to further enable the Fund to administer its own personnel services without state subsidy. Title 38, Chapter 4, mandates that Fund personnel receive salary, travel reimbursement, and health benefit packages subject to the provisions of the state personnel system and the Department of Administration - another program not accessible to the Fund's competing carriers. This change is consistent with the recommendations of the auditor General.

APPENDIX I

LEGISLATIVE COUNCIL OPINION

ARIZONA LEGISLATIVE COUNCIL

MEMO

May 18, 1988

TO: Douglas R. Norton, Auditor General

FROM: Arizona Legislative Council

RE: Request for Research and Statutory Interpretation (O-88-1)

This memo is sent in response to a request made on your behalf by William Thomson in a memo dated April 18, 1988.

FACT SITUATION A:

The state compensation fund (SCF) is under the direct supervision of a three member board of directors. Each member must be a policyholder or an employee of a policyholder of the SCF. Arizona Revised Statutes (A.R.S.) section 23-981.01.

Since 1969, when the SCF was separated from the industrial commission, several appointees to the board have purchased policies from the SCF after being appointed. In some instances a member of the board has cancelled his policy before the expiration of his term.

QUESTIONS PRESENTED:

1. May a board member be appointed who is not a policyholder or an employee of a policyholder of the SCF at the time of appointment? May a board member legally serve on the board if the member obtains an SCF policy subsequent to the member's appointment?

2. Must a member of the board of directors remain an SCF policyholder or remain employed by an SCF policyholder for the entire appointment term?

3. If a board member is appointed without meeting the qualifications prescribed in A.R.S. section 23-981.01, what effect would this have on his actions as a board member?

4. Does the governor have the authority to remove a board member?

5. If the governor does not have the authority to remove board members what would be required for the governor to obtain this authority?

ANSWERS:

1. See discussion.

2. Yes.

3. See discussion.

4. Yes.

5. The governor already has this authority.

DISCUSSION:

A person must be a policyholder or an employee of a policyholder to be a member of the board of directors of the SCF. Although the language of the statute creating the qualifications controls, an officer usually must meet the eligibility requirements for his office at the time he is sworn into office or begins to serve. 67 C.J.S. section 18 (1978).

A.R.S. section 23-981.01 requires that a "member" of the board be a policyholder or an employee of a policyholder. The statute does not require that appointment of board members be made from policyholders or employees of policyholders. If a person appointed to the board meets this requirement by the time he is sworn into office and becomes a member of the board, he is qualified to serve.

If a person appointed to the board does not meet the policy requirements at the time the person is sworn into office, the appointment is void. Even though an officer's original appointment is void, if he later qualifies and begins performing his duties, the office is not vacant. The officer can only be removed based on his appointment if a court of competent jurisdiction declares the appointment void. State ex rel. Sullivan v. Moore, 49 Ariz. 51, 64 P.2d 809 (1937); A.R.S. section 38-291. If an appointee to the board who is not qualified when he begins serving as a board member later becomes a policyholder or an employee of a policyholder, he may remain in office for the remainder of the term unless a court declares that his appointment was void or his office becomes vacant for some other reason prescribed in A.R.S. section 38-291.

2. A.R.S. section 23-981.01, subsection A states in part "/e/ach member shall be a policyholder or an employee of a policyholder of the state compensation fund." This language clearly states that as long as a person retains membership on the board the person must meet these requirements.

3. Even though a person appointed to an office does not meet the qualifications for the office, the person may still be found to be a de facto officer. Juliani v. Darrow, 58 Ariz. 296, 119 P.2d 565 (1941). A de facto officer is one whose acts are not those of a lawful officer but are held valid so far as they involve the interests of the public and third persons. State ex rel. Nelson v. Jordan, 104 Ariz. 193, 450 P.2d 383, appeal dismissed 396 U.S. 5. A person may qualify as a de facto officer if the appointment of the person is void because the person is ineligible for the office and the person's ineligibility is unknown to the public.

The acts of a person who is appointed as a member of the board and who is not a policyholder or an employee of a policyholder are valid as to third persons and the public if the person's ineligibility is generally unknown to the public.

4. Members of the board of directors of the SCF are appointed by the governor without the approval of the senate. A.R.S. section 23-981.01. The governor has the duty of supervising all executive officers. A.R.S. section 41-101. This duty and the power to appoint an officer imply the governor's power to remove the officer. Ahern v. Bailey, 104 Ariz. 250, 451 P.2d 30 (1969). An officer appointed without the approval of the senate

may be removed by the governor except as otherwise provided by law. Holmes v. Osborn, 57 Ariz. 522, 115 P.2d 775 (1941).

No statutory provision prevents or regulates the removal of a board member. Because a board member is appointed by the governor without senate approval, the governor may remove a member who no longer qualifies for the office.

5. See discussion of question 4.

FACT SITUTATION B:

Arizona law provides for the continuance of appointments of officers after their term expires in article XXII, section 13, Constitution of Arizona, and A.R.S. section 38-295. According to the SCF's legal counsel, these provisions apply to the SCF board of directors. However, the SCF differs from other state agencies in a number of ways. It is not supported nor is its board of directors compensated with Arizona tax dollars but operates on insurance premiums and investment income. The SCF is also exempt from certain statutory provisions that apply to most other state agencies pursuant to A.R.S. sections 23-986 and 23-981.01.

Currently, one board member whose term has expired continues to serve on the board. This situation has also occurred in the past. For example, at one time a person served on the SCF board of directors for two years after his term expired.

QUESTIONS PRESENTED:

1. Do article XXII, section 13, Constitution of Arizona, and A.R.S. section 38-295 apply to the board of directors of the SCF? If not, is there any provision in Arizona law that allows a board member to serve beyond the appointment term?

2. If a provision exists, are there any time limitations beyond which an expired term may not be extended?

ANSWERS:

1. A.R.S. section 38-295 applies to board members.

2. No.

DISCUSSION:

The constitutional and statutory provisions providing for holding over in office are not identical. Article XXII, section 13, Constitution of Arizona, applies only to elected officers. Sweeny v. State, 23 Ariz. 435, 204 P. 1025 (1922). Board members are appointed so this provision does not apply to them.

A.R.S. section 38-295, subsection B provides in part:

> Every officer shall continue to discharge the duties of the office, although the term has expired, until a successor has qualified.

Office and officer are defined as follows:

> "Office", "board" or "commission" means any office, board or commission of the state, or any political subdivision thereof, the salary or compensation of the incumbent or members of which is paid from a fund raised by taxation or by public revenue.
>
> * * *
>
> "Officer" or "public officer" means the incumbent of any office, member of any board or commission, or his deputy or assistant exercising the powers and duties of the officer, other than clerks or mere employees of the officer.

A.R.S. section 38-101.

The board is a board of this state so whether membership on the board is an office and members are officers depends on whether the board members receive compensation which is paid from a fund raised by taxation or by public revenue. The members are compensated because each member is entitled to receive fifty dollars for every day of actual attendance of board meetings. A.R.S. section 23-981.01, subsection A. Board members' compensation is paid from state compensation fund monies which are derived from premiums paid into the fund and income earned on these monies. A.R.S. section 23-981, subsection B.

These monies are certainly not raised by taxation so the question is whether SCF monies are public revenues. The Arizona supreme court has held SCF monies to be public monies for some purposes but for other purposes the monies might not be public monies. Sims v. Mouer, 41 Ariz. 486, 19 P.2d 679 (1933).

The Sims case considered whether the use of SCF monies to pay for advertisements aimed at defeating an initative to repeal the workers' compensation law violated a statute prohibiting the misuse of public monies. The SCF was under control of the industrial commission at that time. The court held that in relation to the commissioners the monies were public monies. Although the court found that the SCF is analogous in many ways to a private insurance agency, it believed that the commissioners held a position of trust established by statute in regard to the employees who were beneficiaries of the fund. So, for the protection of these monies they are considered public monies.

The purpose of requiring an incumbent to remain in office until a successor is qualified is to protect the public by ensuring that a vacancy in an office does not exist. Graham v. Lockhart, 53 Ariz. 531, 91 P.2d 265 (1939). A vacancy on the SCF board could prevent the board from conducting business because it lacks a quorum. The inability of the board to act could adversely affect the interests of SCF policyholders and their employees. Like the prohibition on the misuse of public monies examined in Sims, A.R.S. section 38-295 protects SCF monies for the beneficiaries of these monies. Therefore, for the purposes of this statute, these monies are also public monies.

Because public monies are used to pay the compensation of board members, they are officers as defined in A.R.S. section 38-101 and the holdover provisions of A.R.S. section 38-295 apply to them.

2. The holdover provisions of A.R.S. section 38-295 are mandatory. An officer's resignation does not affect this duty. The only thing that relieves an officer is the appointment of a qualified successor. Graham v. Lockhart, 538 Ariz. 531, 91 P.2d 265 (1939). For this reason there is no limit on how long a member of the SCF board may continue in office if a qualified successor is not appointed.

FACT SITUATION C:

The investment committee of the SCF is required to establish the investment policy and supervise the investment activities of the SCF. A.R.S. section 23-985. The investment committee makes all investment decisions regarding the nearly six hundred million dollars in reserve and surplus monies currently invested. The board of directors of the SCF has direct supervision over the fund, however.

QUESTION PRESENTED:

1. Does the board of directors have any authority over investment committee decisions?

ANSWER:

1. No.

DISCUSSION:

The SCF is "under the direct supervision of the board of directors". A.R.S. section 23-981.01. To administer the daily operations of the fund the board appoints the manager. His duties are prescribed as follows:

> A manager shall administer the state compensation fund, subject to the authority of the board of directors . . . . The fund shall be applied to insurance and to payment of compensation and expenses as provided in this chapter. The manager has full authority over the fund and may do all things necessary or convenient in the administration of the fund, or in connection with the compensation business to be carried on by him under this chapter, and may adopt rules and regulations for collection, maintenance and disbursement of the fund, and perform all other functions which the laws of this state specifically authorize or which are necessary or appropriate to carry out the functions so authorized.

A.R.S. section 23-981.

The powers and duties of the investment committee are set out in A.R.S. section 23-985:

> A. There is established an investment committee consisting of the manager and the chairman of the board of directors of the state compensation fund and three members, to be appointed by the governor, who are knowledgeable in investments and economics. The committee shall establish the investment policy and supervise the investment activities of the state compensation fund.

* * *

D. The investment committee shall meet at least once each month and may employ a director of investments and such other staff as deemed necessary for the daily administration of the committee's activities.

E. The investment committee shall retain independent investment counsel and shall periodically review and appraise the investment strategy being followed and the effectiveness of such services. Investment counsel shall report at least once a month to the investment committee on investment results and related matters.

F. The investment committee, by resolution, may invest and reinvest the surplus or reserves of the state compensation fund in any legal investments authorized under title 20, chapter 3, article 2.

G. Notwithstanding section 23-982, subsection A, the investment committee may appoint a custodian for the safekeeping of all or any portion of the investments owned by the state compensation fund. The investment committee may create a partnership to act as a nominee and may register stocks, bonds and other investments in the name of such nominee. The state treasurer shall pay all vouchers drawn on the fund for the purchase of securities. The director of investments may sell any of the investments of the state compensation fund if authorized by resolution of the investment committee.

The investment committee is provided with the specific duty to determine investment strategy and supervise investment of SCF monies. Investments are made by resolution of the investment committee. The committee is also authorized to employ a director and staff separate from that of the SCF.

The board of directors has general supervisory authority over the fund including maintenance of the fund. These powers are in conflict with those of the investment committee. A rule of statutory construction provides that if both a general and special statute cover a certain subject they should be construed in harmony. In these circumstances the special statute controls as an exception to the terms of the general provision. Industrial Commission v. Arizona State Highway Commission, 40 Ariz. 163, 10 P.2d 1046 (1932).

Applying this rule to the investment of SCF monies, the board of directors has control over the fund except as provided in A.R.S. section 23-985. In matters concerning investment of SCF monies, the investment committee has the sole authority.

This conclusion is supported by the design of the committee. Investment requires experience and expertise. Three members are appointed by the governor to provide this expertise. The concerns of the SCF are represented by including the chairman of the board and the manager on the investment committee. Having provided for both of these interests on the committee it does not seem that the legislature would allow the committee's decisions to be overruled by the board whose members may have no investment expertise. It is more likely that the legislature intended to have investment decisions made by the investment committee, the majority of whose members are required to have experience in these matters.

cc: William Thomson, Director
Performance Audit Division