

H B

60

COMMITTEE REPORT

HOUSE

2/4/81

FURTHER: FINANCE

(5)

Date: 2-25-81

Mr. Speaker:

The Committee on STATE AFFAIRS has had HB 60

"An Act establishing a risk management and loss prevention program in state government; and providing for an effective date."

under consideration and (a majority of the committee) (the committee) reports it back with the following recommendations:

- do pass  do not pass
- do pass with attached amendments(s)
- replace with CS for HB 60  same title  
 new title
- and recommends CS HB 10 DO PASS
- AND attaches a "Letter of Intent"  New Fiscal Note
- reports it back without recommendation
- referred to the \_\_\_\_\_ Committee

MEMBERS SIGNING  
DO PASS

[Signature]  
[Signature]  
[Signature]  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
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MEMBERS HAVING  
OTHER RECOMMENDATIONS:

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
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 \_\_\_\_\_  
 \_\_\_\_\_

[Signature]  
 CHAIRMAN

STATE OF ALASKA  
THE LEGISLATURE

POUCH Y - STATE CAPITOL  
JUNEAU, ALASKA 99811  
907-465-3800

LEGISLATIVE AFFAIRS AGENCY


MEMORANDUM

February 28, 1981

SUBJECT: Risk Management Legislation  
CSHB 60 (State Affairs)

TO: Representative Mike Miller  
Chairman  
State Affairs Committee

FROM: John B. Chenoweth  
Legislative Counsel



Your committee administrative assistant brought over the original bill with several very specific changes for incorporation into a committee substitute. By the time I finished, I had changed the bill in great measure. I am providing this memorandum by way of explanation of the changes.

The most significant change is the redesignation of all material in sec. 4 of the governor's bill as a new chapter, AS 44.78. I pulled this material from AS 44.21, where originally placed by the governor's draftsman, and moved it because of our drafting policy that tries to keep the provisions establishing the several executive branch departments free of detailed substantive program requirements. Each of the subsections as set out in sec. 4 of the governor's bill is designated a section within AS 44.78. That change alone necessitated a change in cross-references throughout the legislation.

At page 1, line 15, I have deleted "shall" and inserted "may," as requested.

Your next requested change was to insert "if the Board of Regents finds the program is consistent with the management policies of the University of Alaska" at the end of line 16, and that change is made with language slightly revised for clarity of reference.

Representative Mike Miller

Page 2

February 28, 1981

You asked that "Subject to the findings of the Board of Regents under (a) of this section," be added at the beginning of AS 14.20.597(b); I have tried to do so, but felt the need to revise the language so the reference was clearer.

Your final change asked that "any" replace "the" before "risk management fund" in the second line of the new material added by AS 44.21.020(13). I used "a" rather than "any", for only one risk management fund for the University of Alaska is authorized by AS 14.40.297.

The other drafting changes were made on my initiative and include the following:

Throughout the bill, the "program" established is the "risk management and loss provision program"; the "fund" is the "risk management fund."

Page 2, line 2, and page 4, line 8: "which may include but need not be limited to" is shortened to the standard "including but not limited to".

Page 4, line 15: AS 44.21.070(d) of the governor's bill is rewritten to read: "Unless otherwise expressly provided in the appropriation bill" to give greater certainty to where an exception may be found. There is no other vehicle by which the appropriation is made, and that is the logical place to incorporate any exception or exemption to the general legal requirement.

Page 2, line 9: The sentence beginning "The department shall transfer to an affected agency..." is rearranged and I hope that in so doing I have not lost the sense of the sentence -- whatever that may be.

Page 4, line 20: AS 44.78.060 is derived from the last sentence of AS 44.21.070(a) of the governor's bill, and I think you will agree is so unrelated to the material in AS 44.78.010 as to deserve a separate section with caption. By itself, this will highlight for agencies that there is no relief from liability for enforcement and training provided by this legislation.

JBC:blg

Enclosure

A PERFORMANCE REVIEW  
OF THE  
DEPARTMENT OF ADMINISTRATION  
DIVISION OF RISK MANAGEMENT

July 29, 1990

Commissioner, Department of  
Administration

William R. Hudson

Deputy Commissioners, Department  
of Administration:

Administrative Management

Richard A. Smith

Personnel Management

Vacant

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# STATE OF ALASKA

**THE LEGISLATURE**  
BUDGET AND AUDIT COMMITTEE

AUDIT DIVISION  
POUCH W—ALASKA OFFICE BUILDING

FINANCE DIVISION  
POUCH WF—STATE CAPITOL

JUNEAU, ALASKA 99811

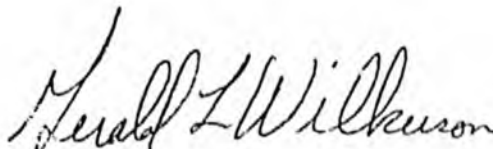
July 29, 1980

Members of the  
Legislative Budget and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

A PERFORMANCE REVIEW  
OF THE  
DEPARTMENT OF ADMINISTRATION  
DIVISION OF RISK MANAGEMENT

July 29, 1980



Gerald L. Wilkerson, CPA  
Legislative Auditor  
Division of Legislative Audit

PURPOSE OF THE REVIEW

In accordance with the provisions of Title 24 of the Alaska Statutes, we conducted a performance review of the Department of Administration, Division of Risk Management, to determine if the agency has complied with Alaska Statutes and has operated in an effective, efficient, and economical manner.

## ORGANIZATION AND FUNCTION

### Organization

Risk Management has undergone significant organizational changes since FY '78. In July 1978, it was transferred from the Department of Administration, Division of General Services and Supply, to the Commissioner's Office. Then in January 1980, it was made a separate division within the Department of Administration. The purpose of both changes was to emphasize the existence and importance of the State's centralized risk management program and to provide greater accountability over its activities.

In addition, Risk Management has expanded in size and scope. In July 1979, four additional professional staff positions were approved, increasing the total number of staff to eight. Two more clerical positions have been approved for FY '81. At the time of this report, however, only six of the Division's ten positions are filled. These are: Division director (risk manager), claims manager, claims examiner, claims recovery officer, contract review officer, and secretary. While the loss control manager and loss control engineer positions are both vacant, the claims examiner is being cross-trained in that capacity.

### Function

In general, Risk Management is responsible for protecting the assets of the State from the risks of accidental loss. The costs of risk are controlled by identifying and analyzing those risks which contribute to loss, and providing the necessary treatment. Each controllable risk will either be retained, transferred to an insurance company or other financially responsible entity, reduced, prevented, or eliminated. To do this, Risk Management utilizes its own staff, coordinates with loss control and safety personnel from other State agencies, and contracts with outside consulting firms and brokers.

In particular, Risk Management is responsible for planning and soliciting insurance coverage. It also handles related financial activities, such as payment of premiums and receipt of insurance reimbursements, monitoring of self-insured retentions and aggregate deductibles, and transfers to and from third parties.

In the last several years, Risk Management has worked with its brokers to obtain insurance that is broader in coverage, but with the deductible portions expanded so that "normal" losses are covered by the State.

## FINDINGS AND RECOMMENDATIONS

### Recommendation No. 1

The Division of Risk Management should solicit proposals from several major insurance brokers prior to entering into FY '82 contracts. Further, brokerage services and computer services should be obtained from different sources.

Marsh & McLennan, Inc. (M/M) has handled substantial portions of the State's insurance for the past several years. Its involvement in the State's risk management program was expanded in FY '78, and the company has served as the State's major broker since that time. The scope of services to be provided in FY '81 includes:

- A. Structuring and placing all lines of insurance for primary coverage.
- B. Developing and recommending risk management programs for the State. For example, M/M participated in an FY '80 review of Alaska's loss control program, and has a separate FY '81 contract to expand and implement recommendations from that review.
- C. Furnishing other special services, such as an FY '79 review of the State's data processing security.
- D. Developing and updating State property valuations.
- E. Providing actuarial loss projections.
- F. Providing computer services for loss data accumulation and cost-of-risk reports. These services were obtained from a different company until mid-FY '80. M/M has provided them since that time.
- G. Assisting Risk Management personnel in audits of claim adjustment procedures.

Risk Management's decision in FY '78 to expand its relationship with M/M - and then to continue and expand that relationship in Fiscal Years '79, '80 and '81 - was based on advice from professional consultants, M/M's professional reputation, financial status and quality of service, etc. It should be noted, however, that when the Division selected

M/M in FY '78 without first soliciting proposals from other brokers, it backed its decision in part with the following statement: ". . . we propose that we begin July 1, 1977 to solicit broker proposals . . . for the FY '79 renewal . . .". To our knowledge this was never done except for excess coverage in FY '81.

We recommend that Risk Management solicit proposals from several major insurance brokers prior to entering into FY '82 contracts. We recognize that this is a complicated process, that it may be appropriate to develop brokerage agreements that last several years, and even that Marsh & McLennan may prove to be the best choice. However, we believe that insurance brokers have a right to compete for the State's business. In addition, good management procedures dictate that the Division do some comparative shopping to be sure that the State is getting brokerage services that are not only of high quality but are also cost effective.

In addition, brokerage services and computer services should be obtained from different sources. Currently, Risk Management contracts with M/M for management information services under a system called "IRIS". Among other things, IRIS provides underwriting data to be utilized by the broker and risk manager in negotiating insurance contracts with underwriters. This data directly affects premium rates and indirectly affects the broker's fee. It is important, therefore, that the Division have adequate controls over data input and output - the most effective way to do this is to obtain computer services from an independent source.

We further suggest that Risk Management consider using the State's own Division of Data Processing in this regard. If the State changes brokers in FY '82, computer services will probably change also. Computer changeovers are costly and inevitably result in errors and information lags. Obtaining services in-house, however, would allow for stability as well as greater control over the data itself.

#### Recommendation No. 2

The Division should strengthen its procedures to ensure that financial transactions are made in accordance with State statutes and the State Administrative Manual, and are properly recorded in the State's accounting system.

This is not a financial compliance audit, and accordingly we did not conduct extensive audit tests of Risk Management's financial transactions. However, a major concern of the

Division is the enactment of legislation that would create a risk management revolving fund. Risk Management believes that this mechanism would enable it to more efficiently administer the Division's financial activity, as well as to more accurately measure and allocate the costs of risk management. In order to evaluate this proposal, we reviewed the Division's current procedures for monitoring and accounting for financial activity. Our review disclosed the following problems:

- A. Financial activities for individual claims are not separately identified in the State accounting system (PBA). In lieu of this, Risk Management relies on the claim data - such as type and date of claim, estimates of potential liability, payments and recoveries, etc. - captured on IRIS. In addition, summary claim data is used as a basis for encumbering funds, allocating the cost of risk among State agencies, negotiating premium rates, and monitoring self-insured retentions and aggregate deductibles.

In most respects, the information generated by IRIS is of greater use to Risk Management than information in PBA because its format and details are more relevant to the Division's needs. Because financial decisions are made on the basis of this data, however, there must be some assurance that actual expenditures and receipts - that is, as reflected in PBA - are being recorded correctly in IRIS. The following examples illustrate this point:

1. IRIS data is used to allocate the cost of risk among State agencies - if data is incorrectly recorded in IRIS, the agency's cost allocation will be distorted. Indeed, we found financial references in case files that couldn't be traced to IRIS or PBA, or that could be traced to one system but not the other.
2. IRIS data is used as a basis for encumbering funds and monitoring self-insured retentions and aggregate deductibles. If expenditures or receipts for a given coverage or year are incorrectly recorded, encumbrances may be insufficient or, alternatively, funds may not be lapsed as required by law. Also, unless

self-insured retentions are properly monitored, the State may pay for losses which should be covered by insurance.

To prevent these or similar problems, we recommend that Risk Management reconcile financial transactions recorded in PBA and IRIS (or any similar computer system contracted for in future years). Reconciliation procedures should include:

1. An alignment of PBA collocation codes with summary data generated by IRIS.
2. Routine reconciliations between PBA and IRIS at these code levels.
3. Audits of claims that include steps to determine whether financial activity is properly recorded in IRIS (see Recommendation No. 3).

- B. We reviewed the majority of Risk Management's prior year encumbrances outstanding as of June 30, 1980. It was our intention to determine whether these encumbrances were valid as defined by Sections 6780-6784 of the State Administrative Manual, whether they were sufficient to meet actual and estimated outstanding claims, and, in general, to become familiar with the accounting problems that occur when claims take several years to complete. However, Risk Management's encumbrance documents were not supported by worksheets that showed the source and basis of amounts encumbered. The risk manager explained the theoretical basis for encumbering funds; however, we were unable to verify whether the theory was actually applied.

We also found that encumbrances are not always used for their stated purposes. For example, the FY '79 fire loss to the State Equipment Fleet's main garage in Palmer was paid for in part as follows:

1. \$165,000 from CC027126, an encumbrance for FY'77 fire damage to a Division of Aviation building at Umiat; and
2. \$316,175 from CC029036, an encumbrance for FY'78 property losses.

With the introduction in FY '80 and '81 of continuing accounts for certain categories of losses, Risk Management will not have to go through the mechanics of establishing encumbrances to prevent funds from automatically lapsing. The Division is still obligated, however, to review year-end obligations and to lapse funds as appropriate. This process should be supported by worksheets and/or other documents that clearly identify the source of information and any computations involved.

- C. During FY '80, subrogation recoveries (cases where State property is damaged by third parties) were not deposited directly to the State Treasury, as required by AS.37.10.050 and the State Administrative Manual Section 6185. They were instead deposited in an outside trust account (See Recommendation No. 3), apparently on the theory that they should be used to offset related expenditures. The Division recently transferred FY '80 subrogation recoveries to the departments who suffered the losses, and plans to transmit future recovery checks upon receipt.

Risk Management is accountable for its use of State funds - as such, it is required to comply with State laws which govern the use of these funds, and to maintain accurate and auditable records of its financial activities. Therefore, we believe the problems discussed above to be significant. It is clear, however, that the Director has neither the time himself nor the staff to make all the necessary improvements. Consequently, we support the Department's efforts to fill an administrative or accounting position whose responsibilities would include monitoring the Division's financial records.

We cannot, however, endorse the concept of a revolving fund until such time as Risk Management improves its accounting procedures.

Recommendation No. 3

The Division should perform or contract for cash disbursement audits of Workers' Compensation and general liability claims.

The bulk of the State's Workers' Compensation and casualty claims are handled by Northern Adjusters in Anchorage. To

facilitate the payment of claims and expenses, Risk Management deposits funds in bank accounts with Northern Adjusters named as trustee. Northern draws against these accounts, and more funds are deposited as needed.

Recognizing the vulnerability of this arrangement, Risk Management has contracted with a major accounting firm to perform periodic bank reconciliations. In addition, Risk Management personnel and consultants from the State's major broker, Marsh and McLennan, perform periodic reviews of Northern Adjusters' claim handling procedures. However, cash disbursements from the fund are not systematically audited for such attributes as: Check is properly supported by a claim file containing appropriate financial documents; check data - amount, payee, year of claim, etc. - is correctly recorded on the IRIS computer runs; check endorsement and deposit information is reasonable; etc.

The funds passing through Northern Adjusters' trust accounts are substantial: over \$900,000 in FY '78, and over \$2,400,000 in FY '79. We therefore recommend that Risk Management either contract with an accounting firm to periodically audit the accounts, or incorporate cash disbursement audit procedures into its in-house audit function. Regardless of who performs such tests, the current cash reconciliation (which does not constitute an audit) could be expanded without significantly increasing cost. Any contract, of course, should be bid competitively.

#### Recommendation No. 4

Risk Management should keep Treasury informed of all bank accounts and investments into which it advances State funds.

As discussed in the previous recommendation, Risk Management has bank trust accounts with Northern Adjusters. In addition, it has had similar accounts with other insurance adjusters, and Northern also acts as trustee for certain investments of State funds.

We found at least ten such accounts or investments that existed during FY '79 or FY '80, none of which had been reported to the Department of Revenue, Treasury Division. The State Administrative Manual, Section 6185, expressly states: "An agency must obtain permission from the Treasury Division of the Department of Revenue to maintain any bank account." In addition, Treasury issued a June 23, 1980 memo to all State fiscal officers asking for a list of all bank

accounts into which State funds have been deposited, and directing that a copy of each monthly bank statement be sent to Treasury prior to the 10th of each month.

We recommend that Risk Management prepare such a listing, implement procedures to obtain and copy to Treasury all monthly bank statements, and obtain permission from Treasury prior to establishing any new accounts.

Recommendation No. 5

Risk Management should develop written procedure that outline insurance requirements for personal service contracts; these procedures should be incorporated into the State Administrative Manual.

In FY '80 Risk Management was approved four new positions, one of which was to be primarily responsible for the Division's contract review program. Duties were to include advising in the proper design of standard contracts, reviewing non-standard contracts for risk and insurance provisions, and obtaining evidence of insurance from contractors. In addition, Risk Management projected that adding the position would enable it to review 60% of all "risk" contracts and, by so doing, to effectuate savings of approximately \$300,000.

It is difficult to measure savings that result from a loss prevention program - such as contract review - and the 60% and \$300,000 projections were not based on hard data. Consequently, we could not determine whether these objectives were achieved. However, the Division has made progress in implementing contract review procedures. For example, Risk Management is copied on most construction contracts and has some input on contract wording and insurance coverage. In addition, the Division worked in conjunction with the Division of Finance and the Department of Law to develop a standardized professional services contract which contains adequate insurance provisions.

In conjunction with its current efforts, Risk Management should develop written procedures that outline what minimum insurance requirements are, define what constitutes satisfactory evidence of insurance, and explain the need for monitoring insurance throughout the contract term. Moreover, these procedures should be incorporated in the Personal Services Contracts chapter of the State Administrative Manual.

Recommendation No. 6

The Division should develop an annual report that provides a more complete picture of the State's Risk Management program.

The State Annual Financial Report reflects certain year-end balances and insurance holdings of the Division of Risk Management, but does not provide complete disclosure of the Division's financial activities. There are also computer runs and memoranda that contain other relevant information. However, there is no one report that provides agencies (which pay the costs of the program), legislators, or other interested parties with a total picture of the State's Risk Management program.

We recommend that the Division develop a report which includes information such as:

- A. Assets - including receivables and monies held in trust accounts or investments outside the State Treasury.
- B. Claims paid or accrued.
- C. Estimated obligations for claims that have not been settled or perhaps not even initiated (actuarial projections).
- D. A breakdown, by year, of aggregate deductible or self-insured retention balances.
- E. Insurance settlements.
- F. A comparison of costs charged to State agencies versus actual costs incurred or accrued.

Suggestions for exhibits and formatting can be obtained from the annual statements that insurance companies are required to file with the State Division of Insurance.

\* \* \*

The following recommendation is directed to the Department of Administration, Division of Finance:

Recommendation No. 7

The Division of Finance should use historical costs for building values reported in the State Annual Financial Report, rather than values developed by the Division of Risk Management for insurance purposes.

Generally accepted accounting principles require that buildings and improvements be reported at cost. However, building values reported in the last several State annual reports have been determined from property lists developed by the Division of Risk Management for insurance purpose. In general, these lists reflect estimated replacement values, not historical cost. As a result of this practice, we have consistently issued an adverse opinion on the Statement of General Fixed Assets for those agencies whose fixed asset holdings are materially affected by building values.

This is, in short, an old issue. In previous audits, however, our scope encompassed only a small part of the State's buildings, and did not illustrate how much this reporting policy affects the State's balance sheet. But in our audit of Risk Management, we looked at the various building listings as a whole and made the following observations:

- A. Insurance values for buildings are periodically increased to reflect inflation rates. In FY '80, for example, values on the insurance listing were increased by 12.5%. If the Division of Finance uses these values in the FY '80 annual report, the "cost" of the State's assets as reported in the FY '79 annual report will be increased by more than \$60 million.
- B. In a limited comparison of the building costs shown on the State's property list to their FY '79 insurance values, we found that insurance values were more than 30% above cost as shown on the State property list. This means that buildings and improvements reported in the FY '79 Annual Report could possibly be over \$100 million greater than what generally accepted accounting principles permit.
- C. There are other discrepancies between building values shown on the State property list and the insurance list. In several instances, buildings appear on one list and not the other - it is unknown whether one or both lists are incorrect.

It is not appropriate that the State's assets should be increased on the basis of arbitrarily and inconsistently applied inflation factors. Further, it is not clear that the insurance lists are any more accurate than the State's property list. The Department of Transportation and Public Facilities (DOTPF) is currently conducting an inventory of

the State's buildings, and is working to develop historical cost data for both existing and newly constructed facilities. We recommend that the Division of Finance work closely with DOTPF in this effort, and that in future annual reports it report building and improvements in accordance with generally accepted accounting principals.

## AUDITOR'S COMMENTS

In recent years the general appropriation act has contained the following provision:

Amounts equivalent to the amounts to be received in settlement of insurance claims for property losses are appropriated from the general fund to the affected agency for the purpose of replacing the facility or service lost as a result of the incident giving rise to the insurance claim.

This section is intended to enable agencies to effect repairs and maintain essential services while awaiting the receipt of insurance settlements. We believe this provision should be clarified in two areas:

1. Agencies do not generally receive settlements directly from insurance companies. Funds are instead transferred from the Division of Risk Management and may be comprised of General Fund monies - if the State's total losses are within its self-insured retention or aggregate deductible limits - as well as insurance recoveries.

The phrase "in settlement of insurance claims" should be clarified as to whether it encompasses funds transferred from Risk Management as well as funds received directly from insurance companies.

2. It should also be clarified what obligation the affected agency and the Division of Budget and Management have to the Legislative Budget and Audit Committee with respect to receiving and expending insurance recoveries.

APPENDIX A

STATE OF ALASKA  
 DEPARTMENT OF ADMINISTRATION  
 DIVISION OF RISK MANAGEMENT  
COMPARISON OF AUTHORIZATIONS, EXPENDITURES AND  
ENCUMBRANCES, FY's 1978 - 1980 (Note 1)

Year	Program	Budget Act	Continuations, Supplements, Revisions	Total	Expenditures	Encumbrances at Close of Year	Balance	
							Continuing Programs	Lapsed
1980	Risk Management-Operations	\$ 280,000	\$ 23,563	\$ 303,563	\$ 283,752	\$ 15,325	\$ -0-	\$ 4,486
	-Premiums (Note 2)	13,568,600	9,354,129	22,922,729	6,851,048	14,313,447	1,650,632	107,602
1979	Risk Management-Operations	173,600	4,248	177,848	164,707	10,241	-0-	2,900
	-Premiums (Note 2)	-0-	20,067,301	20,067,301	7,279,194	10,888,101	-0-	1,900,006
1978	Risk Management (Note 3)	\$ 157,000	\$14,878,645	\$15,035,645	\$6,539,955	\$ 7,893,359	\$ -0-	\$ 602,331

Note 1 Financial data is unaudited and is included for comparative purposes only. FY'78 and '79 data was compiled from State Annual Financial Reports. FY'80 data was compiled State accounting records.

Note 2 The term "Premiums" as used here encompasses all costs of the programs other than operations.

Note 3 The FY'78 Annual Financial Report did not detail "operations" and "premiums".

STATE OF ALASKA

DIVISION OF LEGISLATIVE AUDIT

**DEPARTMENT OF ADMINISTRATION**

DIVISION OF RISK MANAGEMENT

POUCH C  
JUNEAU, ALASKA 99811  
(907) 465-2130

December 5, 1980

Mr. Gerald L. Wilkerson, CPA  
Legislative Auditor  
Division of Legislative Audit  
Pouch W  
Juneau, AK 99811

**RECEIVED**

**DEC 5 1980**

**LEGISLATIVE  
AUDIT**

Dear Mr. Wilkerson:

Re: Preliminary Audit Report  
Division of Risk Management  
Performance Review

We have responded in detail to each item and feel that the audit team has made a start in recognizing some of the problems in operating a statewide Risk Management program. I am disappointed, however, that no audit comment addressed the fact that the State has a sophisticated cost effective program which is probably superior to that of any other major public entity. In addition, there seems to be no recognition of the fact that Risk Management has in fact reduced the cost of risk to each state agency by approximately \$3,000,000.00 over the past three years despite a significant increase in state operations.

We believe that the Risk Management staff is professional and that those contractors which are utilized to supplement that staff are professional. Each contractor's services are negotiated in a performance oriented environment and those contractors who do not meet those performance requirements are replaced or their scope is limited. We believe that due to Risk Management's widespread reliance on these contractors that a "performance" audit should also involve auditing the performance of the contractors. In fact, the auditors have met with Marsh & McLennan to review some concerns directly with that contractor. We will be happy to spend whatever time is necessary with the auditors to satisfy all concerns. However, we wish the audit would have commented on the results of the program which we believe has operated in an effective, efficient, and economical manner.

Recommendation No. 1

- (A) The Division of Risk Management should solicit proposals from several major insurance brokers prior to entering into FY 82 contracts.  
(B) Further, computer services should be obtained from some source other than one providing brokerage services.

A. Agree

The recommendation for broker selection is, of course, one that has been under consideration for the past two to three years. It was determined in Fiscal Year (FY) 1980 to separate the excess insurance from the primary insurance and thus open up a portion of the State account to the smaller Alaska broker so that these brokers could participate and compete on a footing equal to major brokers. The results of the Request for Proposal (RFP) were that two additional Alaska brokers are now involved in the State account for FY 1981. You made some excellent points in discussing the decision to expand Marsh and McLennan's (M&M) services in FY 1978 and subsequently, that the decision was made based on the "quality of service" and "advice from outside professional consultants." This appears to be an excellent method of negotiating professional services. Those who are performing in a cost effective manner receive expanded services and those contractors who are not performing either receive reduced services or are terminated. Ultimately, the selection of the "best" contractor depends on the professional judgment of the program manager. A broker selection decision should be governed by the reasonable expectation that the State will, in fact, benefit by this RFP and will justify the time and expense involved in the process. A decision has been made to go through a full broker selection process for FY 1982 to be effective May 15, 1981.

B. Disagree

The recommendation that computer services be obtained from another source does not appear to be in the best interest of Risk Management at this time. The State owns the data base and simply utilize Marsh and McLennan to coordinate the management information system (IRIS) output in a form that is required by Risk Management and best achieves our objectives. By having Marsh and McLennan handle and be responsible for this coordination, the State is able to save both time and money and at any point could take the service and give it to someone else. All input is handled by someone other than Marsh and McLennan so it is not clear in what way there is a conflict of interest. Since Marsh and McLennan do not receive commissions, there would be no benefit to them to manipulate the data in any way that produces higher costs to the State or otherwise be detrimental to the State.

Presently Risk Management does not have the staff time available to devote to the design of a program with the State Division of Data Processing. The current system meets the Division's requirements at this time.

Recommendation No. 2:

The Division should strengthen its procedures to ensure that financial transactions are made in accordance with State statutes, the State Administrative Manual, and are properly recorded in the state's accounting system.

Disagree

It is our contention that Risk Management and the nature of its fiscal transactions are not completely compatible with PBA. The establishment of a Revolving Fund which the auditors do not support would provide a major relief to the system. The Appendix A supplement illustrates the problem by distorting the actual costs of the program. Manually encumbered funds from prior years are carried forward and inflate the costs of the program. In addition, program receipts such as payments from insurance companies and recoveries from third parties are not credited to the program.

The major concern in this recommendation appears to be the fact that Risk Management utilizes portions of two separate systems to handle the necessary information that is required. The management information system (MIS) was developed to serve several functions:

1. To provide data to be utilized in the claims management program.
2. To provide loss control information which enables the State and each Department to pinpoint those areas contributing to loss and to take necessary corrective action.
3. To provide a cost of risk allocation procedure which is both equitable and accurate.
4. To provide underwriting data to be utilized by the broker and risk manager in negotiating insurance contracts with the insurance underwriters.
5. To assist Peat, Marwick and Mitchell in providing an audit of financial transactions with the State's insurance adjuster, Northern Adjusters of Anchorage.
6. To provide the risk manager with an overview of the State's losses and exposures and a basis of comparison from one year to the next.
7. To provide data by line of coverage to support encumbrances.

The State PBA system is utilized for the recording of expenditure and receipt information in connection with State warrants and program receipts and to provide a tracking for those available funds in each budget component. A second function is to record encumbrance data to

insure that the necessary funds are encumbered to meet state obligations. The recommendation is that the two systems be reconciled by an alignment of collocation codes and it is not clear how this procedure would be accomplished and what the benefit would be to the State. It is Risk Management's intent that IRIS provide the detailed transactions involving each claim or program receipt and that the State PBA system be more general in its financial activity.

A further recommendation had to do with the prior year encumbrances and a statement was made that Risk Management's encumbrance documents were not supported by worksheets that showed the source and basis of amounts encumbered. All Risk Management encumbrances were, in fact, backed up by one of two different methods. For direct damage claims such as fire insurance loss to a building or loss to a state ferry or other item of property, the encumbrance back up consists of the estimated reserve for settlement of the loss, less that amount that may have been paid prior to August 31, of the fiscal year. The balance is the encumbrance. The encumbrances for liability and workers' compensation claims are detailed in the encumbrance report. Risk Management takes those known losses at the close of a fiscal year and utilizes actuarial projections from the State's primary insurance broker to determine the ultimate cost of these claims. This amount is then encumbered as it is the best estimate of the amount of funds that will be needed to ultimately settle the claims which occurred in the fiscal year in question. It should not be difficult to determine that those encumbrances which Risk Management has used in the past are, in fact, highly accurate and justified.

The second portion of the encumbrance recommendation involved utilizing encumbrances for different purposes. The Risk Management system of collocation codes for the various types of insurance and losses is complex. To add to this complexity is the fact that most of the claims take longer than one fiscal year to finally mature and be settled. Without a revolving fund, it is necessary to encumber funds utilizing the best estimate of reserves available at the time and to then revise these amounts as more information is known concerning the settlement of the loss. At times, due to an error in a financial transaction, the wrong account will be utilized to pay a loss, thus creating an imbalance in another account, but with subsequent correction.

A third financial recommendation involved subrogation recoveries and the statement was made that these recoveries were inappropriately deposited into the Northern Adjusters' trust account. The state recovered \$2,325,085.00 in program receipts during FY80. These receipts consisted of \$70,642.00 interest from loss funds, \$39,000.00 miscellaneous recoveries, \$420,899.00 marine insurance proceeds, \$1,734,059.00 property insurance proceeds and \$69,485.00 in subrogation recoveries. The \$2,264,600.00 were deposited into the State general fund. The concern seems to be about the \$69,485.00 which went into the Northern Trust Account. Many of these items were a reduction of expenditures for those particular claims which would have otherwise occurred. Some of the funds were

recovered directly by Risk Management and some of the funds were recovered directly by Northern as part of their required function as a claims adjuster. It is believed that these particular recoveries are in fact appropriately deposited in the trust account as a reduction in expenditures rather than brought in and deposited into the State general fund.

The conclusion of this detailed recommendation is that Risk Management is "accountable for its use of state funds" and required "to maintain accurate and auditable records of its financial activities". We submit that this has been accomplished. Out of a budget of \$13,751.7, Risk Management overhead is 353.1; insurance premiums 4806.0; service contracts 730.9 and losses 7861.7. The overhead, insurance premiums and contracts were reviewed by the auditors. The Northern Adjusters' claim files, however, were not reviewed. The audit of the majority of the Risk Management encumbrances must include the basis for the encumbrances which are the individual casualty claims files at Northern Adjusters. Risk Management has satisfied themselves that the financial transactions are accurate by employing Marsh and McLennan and Peat, Marwick, Mitchell and Company to perform periodic audits.

Risk Management agrees with the need for additional staff. However, a position to do nothing but track items through the State PBA system would not appear to be the best utilization of personnel. The auditor is aware of the administrative positions which were lost in free conference committee during FY 81 budget hearings and that these positions are going to attempt to be reinstated for FY 82.

### Recommendation No. 3

The Division should perform or contract for cash disbursement audits of workers' compensation and general liability claims.

### Disagree

The State incurs approximately 1,500 new claims each year and in addition, there are thousands of claims from prior years which remain open until ultimately settled and closed. It would be impossible with the present staff for Risk Management to handle these claims and they are therefore handled through outside contract adjustment services. The bulk of these claims are handled by Northern Adjusters in Anchorage and in order to handle approximately 700 transactions each month, it is necessary for Northern to maintain a trust account in which they settle and pay claims based on their contract with the State. These claims are then reviewed in detail by Risk Management and by its claims management contractors for proper claims handling procedures. In addition, as part of the brokerage agreement with Marsh and McLennan of Seattle, Peat, Marwick and Mitchell make a quarterly review and audit of the financial transactions which occur between Northern and the trust account. Your recommendation is that these audits are not sufficient and that some kind of representative sampling of claim files be made to verify the

amount of the payment, the individual to whom the payment was made and other factual items. This type of procedure was discussed at great length with the auditors (Peat, Marwick and Mitchell) prior to their initial engagement in auditing the Alpac trust account, and subsequently in their engagement to provide a quarterly audit of the Northern trust accounts. We feel that there are adequate checks and balances as to the type of fraud that could possibly be picked up through an audit of this type. There are numerous checks on the validity of claimants in that each department receives periodically detailed claims runs outlining those individuals who have claims for both liability and workers' compensation against the State. Since these claims runs are used to develop the cost that each agency must pay for Risk Management, the agency is encouraged to review them for accuracy, which would include notifying Risk Management of any individuals who are charged to their department and who are not in that department. This procedure would certainly detect fraudulent claimants. Other checks include the detailed involvement of Risk Management, private attorneys, the Department of Law and individuals from Northern Adjusters in the major open cases. A further check is Marsh and McLennan's Claims Management Services that assists Risk Management in semi-annual audits of the Northern claims files. In reviewing these various review procedures in detail with the outside auditors, it was agreed that this particular type of audit check would not be appropriate for the State considering the extra cost involved.

Recommendation No. 4

Risk Management should keep Treasury informed of all bank accounts and investments into which it advances State funds.

Agree

This recommendation is one in which Risk Management was not familiar. There had been no requests of Risk Management to report account information to Revenue on a periodic basis. This has been corrected and a report of all open trust accounts has been given to Revenue for their information.

Recommendation No. 5

Risk Management should develop written procedures that outline insurance requirements for personal service contracts: These procedures should be incorporated into the State's Administrative Manual.

Agree

Risk Management is now in the middle of contract processing. The insurance provisions for all professional service contracts are supposed to be cleared by Risk Management. In addition, written draft guidelines have been distributed throughout the Department of Transportation and Public Facilities for architects and engineers professional contracts. The projection in savings is difficult to measure, however, \$300,000 is not an excessive figure considering the \$3,000,000 in liability claims that the State incurs each year.

The involvement of Risk Management has created a new awareness throughout the State of the need for proper documentation of insurance certificates. We have received excellent cooperation from the Department of Transportation and Public Facilities Contract Section, for example, who have provided help in establishing standard contract procedures and flagging of nonstandard contracts which require a more detailed review.

The Risk Management Division is working with Contract Officers in each agency to develop written procedures.

Recommendation No. 6

The Division should develop an annual report that provides a more complete picture of the State's Risk Management Program.

Agree

This recommendation is based on developing a report similar to that provided by major insurance companies which would give a detailed financial breakdown of claims, reserves, and an outline of the actual cost of risk incurred. Risk Management thinks that this is an excellent recommendation and will adopt this into an annual report which will serve to communicate much better the actual operation of the Risk Management program and the resulting savings in the cost of risk.

Recommendation No. 7

The Division of Finance should use historical costs for building values reported in the State annual financial report rather than values developed by the Division of Risk Management for insurance purposes.

Agree

This particular recommendation only involves Risk Management indirectly. The information developed for replacement cost is that which Risk Management uses in its insurance value report to the underwriters and is sufficient for these purposes. Risk Management utilizes the best available information to provide this data with the full knowledge that there are considerable activities going on in all areas as to acquisition

Mr. Gerald L. Wilkerson, C-A

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and disposal of property. Risk Management coordinates with the Department of Transportation and Public Facilities who have the statutory responsibility for maintaining building indexes, but it is inevitable that there will be differences between the Department of Transportation and Public Facilities and Risk Management information due to differences in collecting and maintaining data.

Sincerely,



W. R. Hudson  
Commissioner

WRH/JH/bab

# STATE OF ALASKA

## THE LEGISLATURE BUDGET AND AUDIT COMMITTEE

AUDIT DIVISION  
POUCH W—ALASKA OFFICE BUILDING

FINANCE DIVISION  
POUCH WF—STATE CAPITOL  
JUNEAU, ALASKA 99811

December 5, 1980

Members of the  
Legislative Budget and Audit Committee:

We have reviewed the Division of Risk Management's response to our preliminary report. Our comments follow.

### Recommendation No. 1

Risk Management disagrees with our recommendation that brokerage services and computer services be obtained from different sources. One argument is that "the State owns the data base" and "at any point could take the service and give it to someone else." We point out that it takes much more than a data base to produce a management information system. It also takes computer programs. Further, computer changeovers are costly, and service is inevitably disrupted. Therefore, it is to the State's benefit to have a stable computer service. Because the State should be in a position to change brokers without adversely impacting its management information system, we stand by our recommendation that the two services be separated.

### Recommendation No. 2

As pointed out in the report, Risk Management is accountable for its use of State funds. As such, it is required to comply with State laws which govern the use of these funds and to maintain accurate and auditable records of its financial activities. We believe sufficient examples are provided in the body of the report to illustrate that the Division needs to strengthen its procedures in this regard. Major areas of concern are:

1. Inadequate documentation of encumbrances.
2. Two separate computer systems which are not reconciled.
3. Cash receipts not deposited in the State Treasury.

Recommendation No. 3

The Division disagrees with this recommendation because it believes there are already adequate checks and balances over the workers' compensation and general liability claims. As an example, it refers to quarterly "audits" of the Northern Trust Account. Peat, Marwick and Mitchell perform bank reconciliations, not audits, and clearly state in their reports that "We have performed no audit procedures." Another example the Division refers to is the detailed claim listings periodically supplied to departments. It is unrealistic to believe, however, that departments will be able to thoroughly verify these listings. Claimants may not even be employed there any longer.

We believe Risk Management's existing controls are necessary, but not adequate, and reiterate our recommendation for cash disbursement audits. With the use of statistical sampling methods, this should not be a particularly time-consuming or expensive procedure.



Gerald L. Wilkerson, CPA  
Legislative Auditor  
Division of Legislative Audit