



**John Keel, CPA**  
**State Auditor**

An Audit Report on

# **Expenditures at the State Office of Risk Management**

June 2006

Report No. 06-043



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### Overall Conclusion

The State Office of Risk Management (Office) has most of the internal controls necessary to provide reasonable assurance that its expenditures are properly authorized, reasonable, and processed correctly and in a timely manner. Auditors examined the Office's expenditure control activities--which include approvals, authorizations, verifications, reconciliations, and segregation of duties--and a sample of expenditures.

Although all of the expenditures auditors tested were appropriate and reasonable, opportunities exist for the Office to strengthen the processes related to its workers' compensation benefit payments, payroll function, Claims Management System, financial monitoring, information systems, and policies and procedures. In addition, the Office did not have an internal audit function, as required, for a portion of the audit period.

Expenditure categories tested included salaries and wages, professional service fees, and workers' compensation benefits. (Workers' compensation benefits include the medical and indemnity payments for all state employees' workers' compensation claims.) These three categories represented 96.8 percent of the Office's total expenditures during the audit period (see text box). Although the expenditures tested came from selected categories, the internal controls in place are the same for all types of expenditures.

**State Office of Risk Management Expenditures**

The table below contains the amounts the Office expended, by category for fiscal year 2005 and fiscal year 2006 through November 30, 2005.

State Office of Risk Management Expenditures from September 1, 2004 through November 30, 2005		
Category	Amount Expended	Percentage of Total Expenditures
Salaries and Wages	\$ 5,702,981	7.5%
Professional Service Fees	1,634,868	2.2%
Workers' Compensation <sup>a</sup>	66,071,255	87.1%
All Others	2,417,998	3.2%
<b>Total Expenditures</b>	<b>\$75,827,102</b>	<b>100%</b>

<sup>a</sup> The State Office of Risk Management administers the workers' compensation insurance program for state employees.  
 Source: Uniform Statewide Accounting System (USAS) and Uniform Statewide Payroll/Personnel System (USPS)

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Susan Riley, Assistant State Auditor, or John Keel, State Auditor, at (512) 936-9500.

Any system of internal controls has inherent limitations and can provide only reasonable assurance of achieving the control objective, regardless of how well it is designed and operated. Internal controls cannot provide absolute assurance that errors or irregularities would be prevented or detected.

### ***Summary of Management's Response***

The Office generally agrees with the recommendations in this report. Its responses to the recommendations are provided after each set of recommendations, and its overall summary of its responses is in Appendix 2.

### ***Summary of Information Technology Review***

The information technology work conducted at the Office focused on gaining an understanding of the controls in place as of March 2006 for (1) access administration for the Office's Claims Management System and (2) input, processing, and output controls within the Claims Management System. The Office has designed controls to ensure the accuracy and integrity of the billing information contained in its Claims Management System, but it does not have a process to periodically review user access rights to its information systems.

### ***Summary of Objective, Scope, and Methodology***

The audit was to determine whether expenditures at the Office are properly authorized, processed correctly and in a timely manner, and reasonable for the performance of Office functions.

The audit scope included expenditures made from September 2004 through November 2005.

The audit methodology included interviewing personnel; performing analyses of the accounts; reviewing relevant laws, regulations, and Office policies and procedures; and reviewing original documentation.

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# Detailed Results

Chapter 1

## *The Office Should Improve Its Reviews and Tracking of Workers' Compensation Benefit Payments, Including Any Overpayments*

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Most of the 68 workers' compensation benefit payments tested at the State Office of Risk Management (Office), totaling \$20,804, were appropriate and

### State Office of Risk Management Worker's Compensation Insurance Program

The State Office of Risk Management (Office) administers the workers' compensation insurance program for state employees.

The Office charges covered agencies assessments and makes medical and indemnity payments for workers' compensation claims that state employees file.

The Office bases the assessment fees it charges agencies on a formula that includes:

- Claims experience of each covered agency.
- Current and projected size of each covered agency's workforce and payroll.
- Related costs incurred in administering claims.

Source: Texas Labor Code, Chapter 412

reasonable. Auditors identified opportunities for the Office to strengthen its internal controls over the workers' compensation benefit payment process by strengthening its reviews of those payments, collection of overpayments, and tracking and monitoring of overpayments.

The Office's audits of workers' compensation claims do not always identify overpayments on claims in time to completely recover the overpayments. Office policy requires these audits to be conducted within certain timeframes, including prior to the inactivation of a claim.

One of the 34 workers' compensation indemnity payments auditors tested contained a \$734 overpayment

that was not recoverable. This overpayment, which was caused by a transposition error, was not identified by the Office's audits. The Office also made unrecoverable overpayments on four other claims that were related to the indemnity payments auditors tested. These four overpayments occurred primarily because the claimants' employing agencies did not submit documents in a timely manner. The Office's audits of workers' compensation claims did identify these four overpayments. Together, the five unrecoverable overpayments that auditors identified totaled \$3,392.

One of the 34 workers' compensation claims auditors tested was underpaid by \$91. The Office corrected this underpayment after detecting it through its audits of workers' compensation claims.

Although the amount of the unrecoverable overpayments auditors identified is small (\$3,392), the Office still should address risks related to overpayments. While medical payments are based upon the cost as billed by the medical

#### Workers' Compensation Indemnity Payments

There are five types of indemnity payments:

- Temporary income benefits
- Supplemental income benefits
- Death income benefits
- Impairment income benefits
- Lifetime income benefits

The timeliness and accuracy of indemnity benefits payments are usually dependent upon the timely submission of documentation by the claimant's employing agency. Examples of processes and information used to calculate indemnity payments include:

- Determination of eligibility
- Determination of claimant's impairment rating
- Calculation of average weekly wage
- Claimant's work schedule
- Work status reports from doctors.

Source: State Office of Risk Management procedures

service provider, indemnity payments are calculated using case-specific information (see text box for additional details).

Accurate review of all claims is critical to ensuring that overpayments are identified before the last benefit payment is made to the claimant. Historical tracking and monitoring of the overpayments is done in the Office's automated Claims Management System, where users enter notes in a comment field. The Office also tracks overpayments using electronic spreadsheets. Neither process enables the Office to readily identify how many overpayments have been made for a given period or the total amount of overpayments.

The Office does not have a formal policy for recovering overpayments. Currently, it deducts the amount of any overpayment it identifies from future payments to the

claimant. However, this method of recouping overpayments works only when the amount of any remaining future payments exceeds the amount of the overpayment. The State's workers' compensation insurance program absorbs the cost of these overpayments. The program's funds are generated through (1) assessments the Office charges state agencies for workers' compensation coverage, (2) subrogation receipts, and (3) court-ordered restitution.

Without identifying the amount of overpayments it makes, it is difficult for the Office to determine the resources it should devote to additional collection efforts.

#### Recommendations

The Office should:

- Develop internal controls to ensure that established policies for performing audits of workers' compensation claims are completed within the required timeframes. These internal controls should also be documented in Office policy and procedures.
- Develop methods to track and monitor the overpayment of workers' compensation benefits.
- Consider modifying its Claims Management System to capture overpayment and underpayment information in discrete fields specifically for that information.

- Develop internal controls to ensure that the Office regularly reviews overpayments and uses information from that review to make management decisions regarding overpayments.
- Develop effective alternative methods to collect workers' compensation overpayments for cases in which there are no anticipated future payments from which to deduct overpayments. After the total amount of overpayments has been established, the cost-effectiveness of alternative collection methods can be evaluated.

### Management's Response

*Internal controls regarding audit of workers' compensation claims and overpayment will be reviewed and documented in Office policy and procedures. The Office will investigate the recommended modifications to the Claims Management System respecting overpayment/underpayment tracking. The Office will also study the feasibility of alternative overpayment collection methodologies as permitted by law.*

## ***The Office Should Improve its Reviews of the Information That Supports Salary and Wage Expenditures***

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The 65 salary and wage expenditures auditors tested, totaling \$195,078, appear to be appropriate and reasonable. However, because of weaknesses identified in timesheet processes (discussed below), auditors cannot be certain that the overtime expenditures tested were correct.

Auditors identified opportunities for the Office to strengthen its internal controls over the payroll process. Currently, the Office requires employees to submit weekly time sheets (referred to as “leave requests”), as well as monthly time records. For 9 (39 percent) of the 23 overtime expenditures auditors tested, there were discrepancies between weekly time sheets and monthly time records. Both the weekly time sheets and monthly time records are signed by the employee and a supervisor, but there is no reconciliation between the documents. Payroll expenditures were based on the weekly time sheets. Without a reconciliation of these forms, the Office cannot ensure that employee time is recorded and paid correctly.

The Office paid employees for all of the overtime auditors tested. However, the Office also is not following its policy requiring prior approval of overtime. None of the 23 overtime payroll expenditures auditors tested contained the required approval. Although the Office stated that prior approval may not be obtained in emergency situations, its policy does not contain procedures for approval of overtime work in emergency situations.

### **Recommendations**

The Office should:

- Develop and document procedures to reconcile leave requests with monthly time and leave records.
- Follow its overtime approval policy and document approval procedures for emergency situations. This policy should also define what situations qualify as emergency situations.

### **Management’s Response**

*The Office will consider alternative methods of tracking and/or reconciling monthly time and leave records, and strengthen its overtime approval policy and procedures, including emergency leave provisions.*

## ***The Office Should Improve Monitoring of Its Financial Activities***

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The Office relies on Office of the Attorney General staff to monitor the Office's financial activity, including budget comparisons. However, it is ultimately the Office's responsibility to document its own monitoring and reconciliation of financial transactions. The Office does not have documented processes to communicate information about the correction of accounting errors to the Office of the Attorney General. In fiscal year 2006, the Office was appropriated \$7.9 million for risk management and administration of the State's workers' compensation plan and \$60 million for payment of workers' compensation claims for state employees.

Texas Labor Code, Section 412.0111, requires the Office of the Attorney General to provide facilities for the Office but specifies that the Office shall be independent of the Office of the Attorney General. The Office's memorandum of understanding with the Office of the Attorney General establishes a framework for the relationship between these two agencies by delegating to the Office of the Attorney General payment processing in the Uniform Statewide Accounting System (USAS) and Uniform Statewide Payroll/Personnel System (USPS). This memorandum does not delegate to the Office of the Attorney General the responsibility for budget monitoring or financial reconciliations between internal accounting systems and USAS.

The Office should manage its budget by establishing internal controls to ensure that financial activity is properly approved and recorded. Reconciliations and formalized control processes help ensure that all financial activity is processed accurately.

### **Recommendation**

The Office should establish and document internal controls, including timely reconciliations of financial information, to ensure that financial activity is recorded and processed correctly.

### **Management's Response**

*The Office agrees that the existing monthly internal processes regarding reconciliation and correction of errors can be better defined and documented. In conjunction with the Attorney General, the Office will investigate all necessary and appropriate controls to ensure that financial activity is recorded and processed correctly.*

## ***The Office Should Regularly Review Access to its Automated Claims Management System***

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The Office has designed controls to ensure the accuracy and integrity of the billing information contained in its automated Claims Management System, but it does not have a process to periodically review user access rights to its information systems. One employee's access rights were not terminated for a year after this employee left the Office.

Without a process to reconcile user access rights with a list of current employees, the risk of unauthorized access increases. Currently, such a reconciliation process would need to be coordinated with the Office of the Attorney General because the Office of the Attorney General controls access to the mainframe on which the Office's systems reside.

### **Recommendation**

The Office should establish and document a procedure to regularly review user access to information systems and remove access for users whose employment has been terminated.

### **Management's Response**

*The technical process currently exists to automatically delete access to the Claims Management System for all employees upon termination. The Office will work with the Attorney General to establish a process for the reconciliations recommended.*

## ***The Office Should Comply with the Statutory Requirement to Have an Internal Audit Function***

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The Office has not had an internal audit function in fiscal year 2006. In May 2005, the Office did not renew its contract with its internal auditor. In April 2006, the Office requested and was granted a delegation of audit authority, and it began the process to request proposals for an internal auditor.

Texas Government Code, Chapter 2102, requires certain state agencies (including the Office) to have an internal audit function that includes preparation of an annual audit plan and periodic audits of major systems and controls. Without an internal audit function, the Office did not comply with this statute and it also did not have an independent and objective party to perform assurance and consulting services.

Having an internal audit function helps an organization accomplish its objectives by providing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes throughout the year. Review of the organization's activities on a regular basis provides an opportunity to make needed changes in a timely manner and to implement any cost-saving procedures identified by the internal audit function.

### **Recommendation**

The Office should comply with all applicable terms of Texas Government Code, Chapter 2102, including maintaining an internal audit function.

### **Management's Response**

*As noted above, the Office has previously requested and has been granted a delegation of audit authority, and is currently involved in the procurement process for these services. The Office will be in full compliance with the requirements of Texas Government Code, Chapter 2102, for Fiscal Year 2006.*

## ***The Office Should Review and Update Its Policies and Procedures for Specific Functions***

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The Office had not annually reviewed and updated the policies and procedures that auditors examined. The Office's policy requires an annual review of policies and procedures. The Office also lacked complete, documented policies and procedures for fund accounting, recovery of workers' compensation overpayments, overtime approval in emergency situations, and timesheet reconciliations.

The Office's fund accounting function is responsible for processing and issuing workers' compensation medical and indemnity payments, maintaining medical records of state employees who file workers' compensation claims, and reporting Office fund balances. In August 2005, the Office's internal auditor identified similar issues related to lack of documented procedures. Without documented procedures, there is an increased risk that steps may be performed incorrectly or overlooked, particularly when key employees are unavailable.

### **Recommendations**

The Office should:

- Document and update policies and procedures for all divisions to ensure that all required steps are performed correctly, particularly when key employees are unavailable.
- Review and update its policies and procedures annually in accordance with Office policy.

### **Management's Response**

*Policies and procedures will be reviewed and updated in accordance with Office policy.*

# Appendices

## Appendix 1

### **Objective, Scope, and Methodology**

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#### **Objective**

The audit objective was to determine whether expenditures at the State Office of Risk Management (Office) are properly authorized, processed correctly and in a timely manner, and reasonable for the performance of Office functions.

#### **Scope**

The audit scope included expenditures made from September 2004 through November 2005.

#### **Methodology**

Auditors interviewed personnel; performed analyses of the accounts; reviewed relevant laws, regulations, and Office policies and procedures; and reviewed original documentation. The information technology work conducted at the Office focused on gaining an understanding of the controls in place as of March 2006 for (1) access administration for the Office's Claims Management System and (2) input, processing, and output controls within the Claims Management System.

#### **Project Information**

This audit was conducted in accordance with generally accepted government auditing standards. We conducted fieldwork from January through April 2006. The following members of the State Auditor's staff performed the audit work:

- Robert G. Kiker, CGAP (Project Manager)
- Margaret Nicklas, CGAP, CIA (Assistant Project Manager)
- Kelli Davis
- Priscilla Garza
- Anne Hoel
- Terry R. Nickel, CIA, CFE, CFSA, CBM
- Namita Pai

- Rachel Snell, MPA
- Leslie Ashton, CPA (Quality Control Reviewer)
- Susan Riley, CPA (Assistant State Auditor)

## *Management's Summary of Responses*

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The State Office of Risk Management provided the following summary of its responses:

*We have had an opportunity to fully review the draft of your report on expenditures at the State Office of Risk Management (Office). I thank you and your staff for the time you spent learning about the Office, and for identifying opportunities for improvement in our processes and procedures.*

*I know that the Office's administrative attachment to the Office of the Attorney General (OAG) pursuant to Texas Labor Code §412.0111 presented novel issues in the performance of your audit work. The Legislature's creation of the Office as a small, focused, independent entity administratively attached to a larger more administratively sophisticated entity has been successful in allowing us to focus on our mission without duplicating the administrative cost of a fully independent organization. In that context we wholly agree that we are ultimately responsible for the operations of the agency though we work within the parameters of our partnership with the OAG.*

*The SAO staff has been particularly helpful to the Office in identifying the need for review of established policies and procedures. In recent years the Office has undergone rapid evolution in its effort to reduce the incidence and cost of injuries to state employees; while that effort has reduced expenditures by tens of millions of dollars, documenting the evolution of procedures has not been prioritized, and we agree that prioritizing this documentation is necessary. We will strive to implement the recommendations of the audit team in the context of the Office's cooperative partnership with the OAG.*

Copies of this report have been distributed to the following:

### **Legislative Audit Committee**

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair  
The Honorable Tom Craddick, Speaker of the House, Joint Chair  
The Honorable Steve Ogden, Senate Finance Committee  
The Honorable Thomas “Tommy” Williams, Member, Texas Senate  
The Honorable Jim Pitts, House Appropriations Committee  
The Honorable Jim Keffer, House Ways and Means Committee

### **Office of the Governor**

The Honorable Rick Perry, Governor

### **State Office of Risk Management**

Members of the Board of Directors

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Dr. Ronald D. Beals

Mr. Kenneth N. Mitchell

Ms. Martha A. Rider

Mr. Ron J. Walenta

Mr. Jonathan D. Bow, Executive Director



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