PERFORMANCE AUDIT

DEPARTMENT OF ADMINISTRATION

FINANCIAL SERVICES DIVISION

Report to the Arizona Legislature
By the Auditor General
November 1995
Report #95-11

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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November 15, 1995

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. Rudy Serino, Director
Arizona Department of Administration

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Administration, Financial Services Division. This report is in response to a May 5, 1993, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review set forth in A.R.S. §§41-2951 through 41-2957.

This report addresses areas for improvement in two of the Financial Services Division's three sections: General Accounting Office (GAO) and Risk Management Section(RMS). Our review of the General Accounting Office revealed that the potential for improprieties and inaccuracies in the State's financial information exists under the current Uniform Statewide Accounting System (USAS). Moreover, we found that the USAS has been unable to provide a complete representation of the State's financial position, provide agencies with better budgeting information, and eliminate the need for duplicate financial systems. These issues can be addressed and other important financial activities achieved with the establishment of a Chief Financial Officer. Currently, the State's General Accountant resides at a level too low within State government to adequately perform important financial activities and to serve as an equal participant with agency heads on financial matters, thereby placing the State in a reactive position regarding financial management.

Our review of the Risk Management Section revealed numerous problems in the property and liability unit's claims handling methods that expose the State to increased claims settlement costs, inappropriate expenditures, and the potential for fraud. Many of these problems can be resolved by following good claims management practices.

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In addition, we identified the need for RMS to provide agencies with stronger incentives to control losses.

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

This report will be released to the public on November 16, 1995.

Sincerely,

Douglas R. Norton

Douglas R. Norton
Auditor General

Enclosure

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Department of Administration (DOA), Financial Services Division, pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957 and is the fifth of six audits scheduled on the Department.

The Financial Services Division is comprised of three separate units: the General Accounting Office (GAO), the Risk Management Section (RMS), and the State Procurement Office (SPO). This report focuses on two of these areas — the General Accounting Office and the Risk Management Section. The State Procurement Office was not reviewed because it had recently completed a study of its operations that recommends substantial change. Given the magnitude of expected changes to the State's procurement process, we did not believe it would be cost-effective to conduct a review at this time.

The Integrity of the State's Financial Information Remains at Risk (See pages 5 through 9)

The potential for improprieties and inaccuracies in the State's financial information exists under the current statewide accounting system. When the State converted to a new Uniform Statewide Accounting System (USAS) in July 1992, it went from a centralized, paper transaction, accounting process handled by the DOA's General Accounting Office to a decentralized, on-line system with agency staff responsible for all accounting transactions. Unfortunately, the DOA has not provided an adequate internal control structure for this new process (i.e., agencies processing transactions on-line), leaving public funds vulnerable to improprieties. Such improprieties have occurred in at least two instances in the past three years when agency staff have manipulated the system in fraudulent schemes. In a recent review of statewide internal controls, our Office found the potential for such problems still exists.

Additionally, the DOA failed to provide agencies with the necessary training to properly use the new accounting system. As a result, some agencies have had difficulty in processing daily accounting transactions. For example, the GAO discovered (at a small agency that had virtually run out of appropriations) that an accounting technician III responsible for processing receipts had not deposited approximately $150,000 in money orders and checks because she did not understand how to process them.

The GAO will need to improve the system's internal control structure by assuming some agencies' accounting responsibilities. Furthermore, it will need to develop a plan to deal with the current training deficiencies.

The Statewide Accounting System Unable to Readily Portray Arizona's Financial Position (See pages 11 through 17)

The statewide accounting system currently does not meet Arizona's financial management needs. In fact, none of the primary goals for the system (i.e., to provide a complete representation of the State's financial position and to eliminate the need for duplicate systems) have been achieved. For example, financial information such as cash on hand, various bank and trust fund accounts, and short- and long-term liabilities must be obtained from each state agency. In addition, the system is not integrated with procurement transactions and payroll information is not transferred to the accounting system until one week after the close of the pay period. This lack of system integration and timeliness may result in misleading budget information. Finally, many agencies continue to maintain their own financial systems, contending that USAS does not meet their day-to-day financial management needs.

To ensure USAS is able to meet its original expectations, several system improvements will be required. For example, the GAO will need to determine if the system's current software can be enhanced or if new software (at an estimated cost of $1.1 million) is needed. Also, the GAO must ensure the current plan to integrate procurement activities is completed. Additionally, the DOA will need to take the steps necessary to enable agencies to maintain full financial information on the system, including assessing the additional needs of the three largest agencies, equipping USAS to fulfill those needs and providing additional training or holding discussions with those agencies who are able to keep full information on the system, but are currently not doing so.

The State Needs a Chief Financial Officer (See pages 19 through 26)

Despite its $11 billion budget, Arizona lacks a key management component common in the private sector, and increasingly used in government — a Chief Financial Officer (CFO). A CFO in the public and private sectors takes a global view of the organization, monitoring its financial position, and works in partnership with the Chief Executive Officer to manage the organization's operations. The closest equivalent Arizona has to a CFO is the State's General Accountant, who resides at a level too low within state government to adequately perform important financial activities and to serve as an equal participant with agency heads on financial matters. Lacking a high-level position with authority to ensure that important financial activities are achieved, the State has been put in a reactive position regarding the stewardship of public monies and financial management in general.

Arizona should follow the lead of other states and the federal government in prioritizing the need for strong financial management by establishing a Chief Financial Officer position. Further, the CFO should be given the statewide financial duties currently handled by the DOA.

Risk Management's Property and Liability Claims Unit Exhibits Numerous Problems (See pages 27 through 34)

During 1994, the State's risk management program experienced various management problems. For example, it had high vacancies (as high as 30 percent) at both the staff and supervisory level, a high rate of top management turnover, and at least five separate investigations that resulted in four employees being placed on administrative leave, four contracts not being renewed, and an independent adjuster being indicted for fraud.

These difficulties and others have contributed to a number of claims-handling problems, including delays in handling, poor documentation, and a lack of supervision. For example, even though delays generally increase settlement costs, 35 percent of the open claims we reviewed were not being actively adjusted. Similarly, despite its importance, more than 50 percent of the claims lacked adequate documentation, such as billings supporting the payments made. Likewise, most of the files we reviewed contained no evidence of supervisory review. Also, at the time of our review, the RMS staff adjusters had caseloads that were close to twice their recommended standard and the RMS payment processing procedures have suffered from weak internal controls. All of these problems can ultimately result in increased claims settlement costs, unnecessary expenditures, and potential fraud.

To address these concerns, the RMS will need to implement or reintroduce basic claims management techniques including supervision of all claims adjusters. Additionally, it will need to assess the adequacy of its case management system and actively pursue filling its vacant positions.

The RMS Needs to Provide Agencies with Stronger Incentives to Control Losses (See pages 35 through 38)

The RMS should give agencies stronger incentives to control losses. To encourage loss control efforts, the state agency's insurance charges should be linked to its loss history and its loss exposure. Although the RMS uses a cost allocation model to help assess state agencies' insurance charges, this plan has been ineffective in providing the financial incentive necessary to encourage loss control. For example, in the past, the amount charged to some agencies has fluctuated dramatically, due in part to changes in actuarial assumptions and the cost allocation model's failure to reflect actual loss experience because the formula was old, complicated, and prone to errors. To address these concerns, the RMS recently revised its cost allocation model with the overall goals of being simplistic, stable, and responsive, and helping to encourage loss control efforts. Nevertheless, the current method for budgeting for agency insurance costs also provides little incentive. For example, as an agency's insurance costs increase, so does the legislative appropriation to cover the increased charge. As a result, an agency is not likely to feel the ramifications of poor loss control behavior.

To give agencies stronger incentives to control losses, the Risk Management Section should consider using additional tools such as deductibles and premium credits. These mechanisms are widely used by other public risk management entities to increase agencies' willingness to participate in loss prevention measures. For instance, several states impose a $500 to $1,000 deductible on property claims. In addition, some states provide premium reductions, premium credits, or recognition awards to reward agencies' loss control efforts.

Table of Contents

Table of Contents

Table of Contents

Page

Figure

INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Department of Administration (DOA), Financial Services Division, pursuant to a May 5, 1993, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review set forth in Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957 and is the fifth of six audits scheduled on the Department.

Division Overview

Under the direction of an assistant director, the Financial Services Division (FSD) had an authorized full-time staffing level of 280 for fiscal year 1995, and is comprised of three separate sections: the General Accounting Office, the Risk Management Section, and the State Procurement Office.

The General Accounting Office (GAO) — The GAO provides statewide financial services including accounting functions. Its mission is *"to provide statewide financial services, management information and technical assistance while ensuring compliance with related statutes and rules."* GAO's specific responsibilities include:

- Preparing and distributing the statewide payroll;
- Preparing and distributing payments to vendors and others receiving compensation from the State for services rendered;
- Providing financial information to state agencies, federal government agencies, financial institutions, and other interested public or private entities;
- Maintaining the statewide automated financial system;
- Preparing financial reports; and
- Reviewing and revising financial policies and procedures.

The Risk Management Section (RMS) — The RMS acts as the State's insurance carrier and thus is responsible for protecting state assets, including property, personnel, and revenue from accidental and unintended losses. For many years the RMS functioned as its own division within the DOA. However, in 1993, due to a reorganization of the DOA, the risk management function was brought into the Financial Services Division. This unit also underwent another significant change in January 1994 when the state workers' compensation function was brought in-house.(1)

The RMS' mission is *"to promptly provide high quality services for cost-effective management of state property, liability and workers' compensation exposures."* To ensure assets are protected, this program performs several functions:

- Provides insurance or self-insurance for all state agencies, boards, and commissions;
- Investigates, mitigates, and settles all property and liability claims against the State;(2)
- Investigates and manages workers' compensation benefits for injured state employees;
- Defends lawsuits and recovers monies from third parties who have injured the State;
- Assists agencies in the development and administration of loss control programs; and
- Assists agencies in administering return to work programs in compliance with the federal Americans with Disabilities Act (ADA).

The State Procurement Office (SPO) — The Director of the DOA, primarily through the SPO, acts as the centralized procurement authority. The SPO's mission statement reads: *"to promptly provide quality products and services at competitive prices, while at the same time ensuring compliance with State Procurement statutes."* The Director has the authority to delegate procurement authority, and currently many of the State's procurement activities are largely decentralized. Therefore, the SPO concentrates its activities in the following areas:

- Conducting complex procurements, including statewide contracts;
- Managing the cooperative purchasing program for political subdivisions;
- Disseminating procurement information and training its procurement customers; and
- Administering bid protests and claims appeals on behalf of the Director.

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(1) In prior years, the State contracted with the State Compensation Fund to handle workers' compensation claims administration and legal representation.

(2) The RMS has an office in Tucson as well as Phoenix to perform this function.

Budget

The Financial Services Division receives general fund appropriations, appropriations from three other funds (the Automation Fund, the Risk Management Revolving Fund, and the Workers' Compensation Liability Loss Revolving Fund), and nonappropriated funds. For fiscal year 1995 this Division received an estimated $74,253,800 in funding — $74,176,500 in appropriated funding and $77,300 in nonappropriated funding. The majority of the funding is utilized by the Risk Management Section (approximately $60,350,800) for the payment of property, liability, and workers' compensation losses and expenses for adjusting these claims.

Audit Scope and Methodology

This audit focuses primarily on the General Accounting Office and the Risk Management Section. Our work in the GAO centered on the implementation and usefulness of the statewide accounting system. In the Risk Management Section we focused primarily on one of the two claims sections — the property and liability section. The other section, workers' compensation, was not reviewed in great detail because the Risk Management Section has only been handling this function since January 1994, and this function is subject to outside monitoring by the Industrial Commission of Arizona. Additionally, we did not review the State Procurement Office. During our audit, the SPO had completed a study of its operations that recommends substantial change to the State's procurement process. Given the magnitude of expected changes in that Office, we did not believe it would be cost-effective to conduct a review at this time.

Our report presents findings and recommendations in the following areas:

- The changes needed to improve the integrity of the statewide accounting system;
- The extent to which the statewide accounting system fails to meet the State's financial management needs;
- The need for strong financial management in Arizona;
- The need to improve the claims management function; and
- The need to give agencies stronger incentives to control losses.

In addition, we have included an Area for Further Audit Work on the State Procurement Office. This section discusses proposed changes to the State's procurement function and the need to evaluate the effect of those changes at a later date.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Director of the Department of Administration, the Assistant Director of the Division of Financial Services, and their staff for their cooperation and assistance throughout the audit.

FINDING I

THE INTEGRITY OF THE STATE'S FINANCIAL INFORMATION REMAINS AT RISK

On October 21, 1992, three months after the State implemented a new uniform statewide accounting system, a local bank notified the State of unusual activity in a personal checking account involving state warrants. An investigation subsequently determined that an administrative service officer at a state agency had entered transactions into the statewide accounting system to authorize the issuance of 23 state warrants made payable to a phantom vendor and ultimately misappropriated $1,878,688 in state monies.

To date, the integrity of the State's financial information remains at risk. Weak internal controls within agencies continue to expose the State to additional improprieties. Moreover, agency personnel responsible for financial transactions do not have sufficient knowledge to utilize the system. System changes and additional training are needed to improve the system's reliability and security.

In July 1992 Arizona converted to a new Uniform Statewide Accounting System (USAS) to improve state financial management, budgeting, and reporting capabilities. Prior to USAS, most agencies submitted paper financial transactions to the GAO for central processing. This procedure required little computer or accounting knowledge on the part of agency staff. Further, agency staff had only partial responsibility for processing financial transactions. The new system shifted the emphasis from paper processing to computerized accounting at the agency level. Today, agencies process their own financial transactions and have on-line access to data, making computer and accounting skills and proper internal controls essential.

Weak Internal Controls Jeopardize System Security

When the State converted to USAS, it neglected to address fundamental internal control issues at the agency level, jeopardizing system security and, in some cases, resulting in outright fraud. Greater oversight and limited system access is needed to improve the system's security.

Weak internal controls — The DOA has failed in its obligation to provide an adequate internal control structure for the State, leaving public monies vulnerable to future improprieties. Internal controls are designed to prevent one person from gaining control over processing accounting data and documents. Such controls became especially important when financial transactions were decentralized and access to sensitive files was opened to agencies. For example, the file that is essential to processing all state warrants, known as the vendor file, is now accessible to agencies.[1] Therefore, under the current system, if proper controls are not in place at an agency (such as "segregation of duties"), an employee could enter his or her name into the vendor file, enter a claim for payment, release the claim for processing, and collect the warrant (i.e., check) at the GAO.

Agencies became responsible for instituting proper controls for the automated system when USAS was implemented, although the GAO is ultimately responsible for the system's security. However, implementation of control procedures has not occurred to the degree necessary. During a recent review of statewide internal controls, our Office found that "financial assets were not adequately safeguarded against loss from unauthorized use or disposition." For example, as of May 1995, (nearly three years after USAS was implemented), almost 30 percent of the persons using the system can still both enter a claim and release it for payment. As a result, improprieties such as the one described in the first case example on page 5 can still occur, as demonstrated in an incident last year:

- In June 1994, a J. C. Penney employee contacted the State regarding three purchase orders and three State of Arizona warrants he had received from a state worker for store merchandise. This worker, an accounting technician from a small state agency, issued state warrants totaling $29,100 for clothing, a new Ford Mustang, a car CD player, and various college and insurance expenses. He had access to enter vendors into the system, enter and release claims, and pick up warrants from the GAO.

Greater oversight and limited system access is needed to improve internal controls — System security will continue to be jeopardized until certain measures are taken to improve the internal control structure of the State. First, the GAO may have to assume responsibility for the accounting functions of some agencies. For example, agencies that repeatedly violate internal control policies should no longer be allowed access. In addition, while we recognize that it is difficult for some smaller agencies to appropriately segregate duties due to limited staff, it does not negate the need for such controls (or alternative solutions). Therefore, smaller agencies that lack sufficient staff to adequately implement internal control procedures may have to transfer their accounting functions back to the GAO. However, the GAO has generally been unwilling to take control in either of these instances because they feel they do not have the resources necessary to perform these agencies' accounting functions.

Additionally, to reduce the possibility of financial inaccuracies and improprieties, system

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(1) The vendor file contains the names of all vendors that conduct business with the State. To process a state warrant, the vendor's name must be contained in this file.

access should be limited based on agency needs. Currently, all agencies have equal access to the system's numerous accounting functions despite their accounting needs. Because accounting needs vary significantly from small to large agencies, access that is linked to agency needs could simplify interaction for basic users without restricting access for advanced users. More specifically, agencies that perform complex accounting (such as those that have to monitor multiple projects or report on federal grants) should be assigned greater access and receive extensive training on system capabilities. For agencies that use USAS primarily to pay bills and record receipts, access should be limited to the transactions needed for daily operation.

These suggestions, if implemented, will likely result in GAO needing increased staff. Although we did not verify this figure, agency officials estimate that three additional staff would be needed to assume the financial accounting activities of smaller agencies.

Agency Personnel Do Not Have Sufficient Knowledge to Utilize the System

The integrity of the State's financial information is further compromised because agency personnel lack adequate knowledge to effectively operate USAS. Although the new system requires staff with substantially greater skills than the previous system, new skill requirements were not addressed. In addition, inadequate training continues to impede successful operation of USAS.

New skill requirements were not addressed — The skill level needed by agency staff to operate the new accounting system was not addressed when USAS was implemented. Highly skilled accounting staff at the agency level became critical when USAS shifted the responsibility for the accuracy of financial data to the agencies. Because new skill requirements were never addressed, the staff who have the qualifications needed to operate in a paper-driven environment are now responsible for the integrity of the State's financial information under the new complex, automated system. For example, accounting technician III's, who are only required to have nine hours of accounting instruction or equivalent experience, often find themselves responsible for million-dollar budgets. The GAO managers state that, ideally, staff responsible for such duties as budget monitoring and management reporting should have an accounting degree.

Some agencies have tried to resolve personnel problems by recruiting staff who exceed the minimum qualifications. However, low pay impedes their ability to retain employees; hence, these efforts have been largely unsuccessful.

Inadequate training — A knowledgeable user base has been further hindered due to inadequate training. According to one DOA official, a minimum of 40 hours of training is needed to understand how to enter common financial transactions and read reports. An additional 40 hours of training is needed to grasp the system's overall structure. In contrast, when USAS was implemented, agencies received anywhere from 0 to 40 hours. Furthermore, this training was a "one shot deal" and conducted at too technical a level for the average accounting technician. By the GAO's own admission, the training must be simplified and continuous, especially given the turnover among accounting staff at state agencies.

The DOA's initial failure to recognize the importance of training to the successful operation of USAS continues to hinder the accounting system. The following examples illustrate how inadequate training has resulted in financial difficulties and inaccuracies:

- In March 1993, an executive director of a small agency requested assistance from the GAO relating to the processing of accounting transactions. This agency had virtually "run out of appropriations" with three months remaining in the fiscal year. The GAO discovered, among other things, that the accounting technician III, responsible for processing receipts, had not deposited money orders and checks totaling approximately $150,000 because she did not understand how to process them. The GAO finally had to revoke the agency's ability to release transactions because of repeated problems. The GAO now reviews all financial transactions before they are fully processed.

- During a financial audit, a GAO auditor reviewed the records of an agency that was having year-end funding difficulties. The auditor found that agency staff did not know how much money was available because they did not know how to use the system.

- According to a GAO official, on average four agencies exceed their appropriation limits every year. Such incidents are typically not discovered until the system rejects payroll processing because of inadequate monies. This official attributes these problems to lack of system and budgetary knowledge.

Additional training is needed — Additional training is needed to educate agencies on proper system usage. A number of training needs have been identified by the GAO staff, including agency-specific training for both the technician and management levels, continuous general training, and user-friendly manuals that emphasize how to process common financial transactions. Furthermore, to help address high turnover rates among accounting staff, the GAO should require state agency staff to complete training as a condition of being given system access. This training should occur within a specified timeframe from the employee's hire date.

The GAO officials indicated that its current USAS training group consisting of three FTEs is not adequately staffed to provide comprehensive instruction to approximately 120 agencies.[1] The GAO estimates anywhere from two to eight additional staff members are needed to provide the necessary training. However, as the GAO's training group has just recently been established, it is difficult to determine if these numbers are appropriate. Moreover, there is potential to use other staff who are knowledgeable on system capabilities to assist in the training effort. For example, the GAO has five internal auditors and four systems security staff in addition to the training group who could potentially coordinate efforts and better utilize existing internal resources.

Subsequent to the completion of our fieldwork, the GAO implemented a three-year training plan beginning in July 1995. The GAO now offers formalized training classes and publishes a training calendar to inform agencies of class availability. More emphasis is needed, however, on formalizing the coordination between the security, internal audit, and training groups.

RECOMMENDATIONS

1. The GAO should take measures to improve the internal control structure of the State by:

   - Assuming data entry responsibilities of those agencies unable to implement proper internal controls due to limited staff; and

   - Revoking access to those agencies that repeatedly violate internal control policies.

2. The GAO, after consulting with the affected agencies, should consider restricting system access based on agency needs to facilitate system interaction and reduce the possibility of financial inaccuracies.

3. The GAO should require all users to complete training as a condition of having system access. This training should occur within a specified timeframe from the employee's hire date.

4. The GAO should ensure its training plan includes a discussion of how the training, internal audit, and systems security groups can coordinate their efforts to best utilize existing resources.

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[1] There is a fourth position in the training group that is dedicated to training on travel issues only.

FINDING II

THE STATEWIDE ACCOUNTING SYSTEM UNABLE TO READILY PORTRAY ARIZONA'S FINANCIAL POSITION

The uniform statewide accounting system (USAS) fails to meet Arizona's financial management needs. USAS is currently unable to provide both agency and statewide officials with important financial information. It appears that system implementation suffered from a lack of support and resources; factors that continue to hinder the system's capabilities. Several system improvements are needed to ensure the system accurately and readily provides the information necessary to manage the State's finances.

A good financial management system is a critical component in today's financial arena. Its importance was recently illustrated in an article from *Governing* magazine comparing and contrasting the financial successes of other Arizona governmental entities — the City of Phoenix and Maricopa County. This article describes how in 1993, while the City of Phoenix won an international award for its "management virtuosity," Maricopa County was "busy spending itself to the brink of bankruptcy." Although many factors likely contribute to the City of Phoenix's successes, the author is quick to point to one specific factor: *"A sophisticated financial system means the government of Phoenix knows nearly everything about what it is doing, and it knows it very quickly . . . the most important thing it knows is how it is spending its money."*

USAS' Goals

In July 1992, Arizona implemented an automated accounting system to improve its financial management. The primary expectations for the system were that it would:

- Be a complete, fully integrated governmental accounting system that would provide a fair and complete representation of agencies' and the State's financial position;
- Provide agencies with better budgetary information and ad hoc reporting capabilities;
- Eliminate the need for agencies to maintain duplicate financial systems; and
- Process financial transactions in accordance with generally accepted accounting principles for governmental units (GAAP).

To date, USAS has been unable to fulfill these expectations making financial management of the State's programs more difficult.

USAS Does Not Provide Important Financial Information

Numerous problems currently prevent USAS from providing complete and accurate information at both the agency and statewide level. Our review found that important information is missing from USAS, even though it is statutorily required. In addition, the system is not integrated with procurement activities nor does it produce timely financial information. Due in part to USAS' current deficiencies, agencies continue to maintain their own financial systems so they can determine the financial status of their own programs. Finally, financial transactions are not being entered in accordance with generally accepted accounting principles (GAAP) for governmental units.

Important financial information missing — Important components of financial information are missing from the statewide accounting system, even though the DOA is statutorily required to maintain such information. According to A.R.S. §35-131, the DOA *"shall maintain complete, accurate and current financial records relating to state monies . . . expended by each budget unit, including trust monies or other monies not subject to appropriation . . ., in a manner consistent with the uniform state accounting system . . ."* Without this information it becomes difficult to prepare the State's Comprehensive Annual Financial Report (CAFR).(1) For example, such information as cash on hand, various bank and trust fund accounts, receivables, and short- and long-term liabilities must often be obtained from each state agency.(2) It takes several months for the GAO to compile this information. As a result, the financial status of the State is really available only available once a year after the CAFR is completed.

The amount of information maintained on USAS is greatly impacted by the State's three largest agencies that represent nearly 50 percent of its expenditures: the Arizona Health Care Cost Containment System, the Arizona Department of Transportation, and the Department of Economic Security, who do not rely on USAS as their primary accounting system. It appears that the State did not have adequate resources to accommodate the specialized needs of these agencies, so they were not required to convert to USAS. Nevertheless, these agencies were expected to maintain complete information on USAS for reporting purposes. Although these agencies transfer some of their financial data to USAS, significant information continues to be missing from the statewide system.

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(1) The CAFR discloses the State's financial status, and is often used by taxpayers, bond rating agencies, and banking institutions.

(2) Less than 50 percent of the information used to compile the CAFR is obtained from USAS.

System lacks integration and timeliness — Although USAS was intended to be fully integrated with procurement activities and provide accurate and timely financial information, these goals have not been achieved because:

- USAS currently is not integrated with procurement activities; and
- Payroll expenditures are not transferred to the accounting system until one week after the close of the pay period.

As a result, information on the system, such as available appropriations, is exaggerated and can result in both the agencies and the State spending monies that are not available (i.e., monies that have already been committed). For example, if an agency procures the services of a consultant, it has made a commitment to pay for those services; however, if the monies needed for the consultant are not encumbered ("reserved") on the system they may ultimately be spent by another agency official who is not aware of the commitment. Although agencies are required by statute to encumber monies when expenses over $500 are incurred, our review indicates that compliance with this policy is poor. As mentioned previously (see Finding I, pages 5 through 9), overspending may not be discovered until the system rejects payroll processing due to inadequate monies.

Agencies are frustrated by the lack of timely and accurate financial information. For example, a common complaint cited in our agency survey was that USAS does not provide agencies with adequate budget and/or management information (including reports) needed to conduct day-to-day operations.[1] Although GAO has created several management information screens, their effectiveness is hindered by the lack of integration with procurement activities and the delayed transfer of payroll information.

Incomplete and untimely information contributes to agencies maintaining duplicate systems — Although a primary intent for USAS was to eliminate the duplication of resources, this goal has not been achieved. Under the previous system, many agencies maintained their own financial systems because they did not have on-line access to the State's financial information. While USAS has allowed agencies on-line access, it has failed to provide them with timely and complete information, requiring many agencies to continue using their own systems. For example, 19 of the 22 agencies we contacted said they still maintain some form of internal accounting system ranging from paper ledgers to fully automated accounting systems. A GAO employee confirmed that these results are representative of most small and medium-sized agencies. In addition, the largest agencies maintain their own systems, which were in place prior to the implementation of USAS.

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(1) Using an agency listing provided by the GAO, we contacted 22 small, medium, and large agencies to determine the system's ability to meet their financial management needs. This size classification is based on the agency's utilization of the system including the number and type of transactions performed.

Agencies offered several reasons for why they maintain separate systems. While some stemmed from misperceptions about USAS' capabilities due to poor training (see Finding I, pages 5 through 9), other concerns were based on USAS' inability to:

- Provide timely, accurate, and user-friendly financial information;
- Provide meaningful, timely, standardized reports and ad hoc reports; and
- Facilitate the recording of receivables due to an inoperative billing system.

As discussed above, USAS is not integrated with other systems and therefore lacks timely, complete information. Moreover, the GAO's reports that are available are frequently criticized for being untimely and unreadable. These problems are due in part to USAS not having a functional ad hoc reporting tool that would allow agencies to customize their own financial reports, thereby reducing the need for the GAO to do so. Additionally, a billing system is necessary to facilitate the recording of accounts receivable information on USAS. Currently, approximately 40 to 50 percent of the State's agencies provide billable services and rely on their own systems to process invoices and record accounts receivable information. Consequently, such information is missing from USAS.

Transactions not processed in GAAP format — Although lack of integration has hindered USAS' performance, the current accounting method practiced has also impeded USAS' ability to meet the State's original expectations. For example, USAS was intended to provide information in compliance with generally accepted accounting principles (GAAP) for governmental units to facilitate the production of financial reports and to enhance the quality of information available to policy makers. Although the system is capable of processing such information, agencies generally do not enter information on a GAAP basis. When financial transactions are entered on a GAAP basis, monies are basically committed on the system when the obligation to purchase is made rather than waiting until the bill is paid. For the past several years our Office has recommended this method as it provides a more accurate depiction of monies available.

Lack of Support and Resources Contribute to USAS' Failure

Several factors may have contributed to USAS' current inability to meet Arizona's financial management needs. Although DOA consulted with other states and conducted a feasibility study prior to installing the new accounting system, a lack of support and resources may have contributed to its poor implementation and continue to hinder its success today.

Lack of support and resources contribute to poor implementation — Although pre-planning for USAS is evident, its implementation does not appear to have received the support and resources needed for success. Prior to purchasing the new accounting system, the State conducted a feasibility study to determine what functions it needed the new system to perform. Nevertheless, the DOA appears to have underestimated the difficulty in successful system implementation.

According to the *Government Accountants Journal*, key factors in any successful long-term automation project include sufficient resources and securing top management and broad-based support from stakeholders. It appears that the General Accountant, who was ultimately responsible for system implementation, was unable to solicit the support and resources necessary to successfully implement USAS (perhaps due to a lack of authority — see Finding III, pages 19 through 26). For example, according to the GAO staff, the General Accountant submitted a proposal to the Assistant Director of the Financial Services Division explaining the need to upgrade the DOA accounting positions with the advent of USAS. The DOA officials denied the request and informed the General Accountant that "the development of USAS must be within the existing resources."

In addition, the amount of resources Arizona invested in system implementation was low compared to other states with the same system.[1] Three of the four states that also purchased USAS provided cost estimates for system implementation (for software, training, consultants, and reprogramming) ranging from $12 million to $60 million. In contrast, Arizona invested $3 million for these same items.

Many of the system deficiencies have been recognized by the GAO; however, when they will be addressed is uncertain due to a lack of resources and other competing DOA priorities. For example, GAO officials state they do not have the technical staff necessary to perform the reprogramming required to make USAS more user friendly and efficient. Currently, inefficient programming contributes to unnecessarily high system downtime as well as cumbersome user screens. To correct such problems, the GAO must rely on programmers who are located within the DOA's Information Services Division (ISD). However, these programmers are often reassigned to other competing statewide applications. Only 10 of the 14 programmers assigned to the statewide accounting system are working on USAS (8 full-time and 2 part-time). The remainder are working on other statewide applications. This leaves only enough staff to maintain USAS but not enough to make badly needed improvements. Therefore, it is uncertain when these needs will be addressed.

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[1] Maryland, Michigan, Oregon, and Texas all have the USAS system. All of these states, except Maryland, were able to provide us with cost figures for software, training, consultants, and reprogramming. All of the figures cited are for initial implementation costs and do not include any costs for additional enhancements.

Five Changes Needed to Ensure USAS Meets Arizona's Financial Management Needs

USAS could largely fulfill its original goals if actions are taken in five key areas.[1]

First, additional software needs must be addressed. Software needs include a billing system to facilitate the recording of accounts receivable information (needed for GAAP- based accounting methods) and an ad hoc reporting tool to allow agencies to produce customized reports. Both items will assist in eliminating the need for duplicate systems at the agency level. The GAO should conduct feasibility studies to determine if the existing software can be enhanced to meet agency needs or if new software is required. The GAO estimates that new software would cost approximately $1.1 million (this estimate includes the cost of feasibility studies, but not additional equipment agencies may need to use the new software).

Second, the DOA should perform the reprogramming needed to make USAS more user-friendly and efficient. This can be accomplished either by transferring programmers to the GAO or by committing adequate resources in the ISD to meet USAS' day-to-day maintenance needs and make additional enhancements.[2]

Third, to ensure the system provides accurate information, the DOA should ensure that USAS is interfaced with procurement activities and payroll processing delays are minimized. Although the State abandoned the original procurement system that was purchased with USAS, another system has since been purchased. The DOA should make efforts to accelerate this project. Likewise, delays in payroll processing should be addressed either through system changes or by utilizing accounting practices such as encumbering ("reserving") payroll.

Fourth, to improve the quality and quantity of information kept on USAS, the DOA should take the steps necessary to enable agencies to maintain full financial information on the system as required by A.R.S. §35-131. In the case of the three largest agencies that have specialized needs that currently cannot be met by USAS, this will entail the DOA assessing the additional system enhancements required to meet their needs. Then, as a long-term goal, the DOA will need to equip USAS to fulfill these needs.

There are, however, many agencies who could, but do not, keep complete financial information such as revolving funds and budgetary information on USAS. In some cases it

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(1) These recommendations are limited to only those that would likely enable USAS to meet original expectations. They do not address other items needed to enhance the system.

(2) The GAO recently submitted a request to the DOA director to have programmers transferred from ISD to GAO. However, the request was denied.

appears agencies do not keep full information on the system because of a lack of knowledge about the system. Other agencies appear not to put all information on USAS as a means of limiting outside scrutiny of this information. The DOA needs to address these situations through better training and specific discussion with the agencies involved.

Finally, the State should consider requiring some agencies to enter financial data in accordance with GAAP. Because this method is more complex than the current cash-based method, it might be more cost-effective to convert only those agencies that comprise the largest share of the State's revenues and expenditures. GAAP accounting methods would enable the system to report the State's financial position continually throughout the year rather than relying solely on the annual report. Moreover, this method does not preclude the State from reporting on a cash basis if needed.

RECOMMENDATIONS

To improve the statewide accounting system, the DOA should take the following steps:

1. Conduct feasibility studies to determine if the current billing system and ad hoc reporting tool can be enhanced to meet agency needs or if additional software is necessary.

2. Reprogram the system to make it more user friendly and efficient.

3. Interface the system with procurement activities and address payroll processing delays.

4. Improve the quality and quantity of information on USAS by:

   - Assessing the additional system enhancements required by the three largest state agencies to meet their needs, and as a long-term goal, equipping USAS to fulfill those needs; and

   - Ensuring, through better training and specific discussion with agencies, that agencies record complete financial information on the USAS system whenever possible.

5. Consider converting those agencies that comprise the largest share of the State's revenues and expenditures to GAAP basis accounting.

FINDING III

THE STATE NEEDS A CHIEF FINANCIAL OFFICER

Arizona needs a chief financial officer (CFO) to assist in statewide strategic planning and to ensure strong financial management and public accountability. The need for strong financial management is increasing, but DOA's current organizational structure is inadequate to handle the challenge. The private sector should serve as a model for Arizona as it has for other governmental entities.

Although Arizona's $11 billion budget is similar in size to such Fortune 500 companies as Intel, U.S. West, and Chase Manhattan Corporation, the State lacks a key component of most private sector management teams — a Chief Financial Officer (CFO). In the private sector the CFO works in partnership with the Chief Executive Officer (CEO) and the Chief Operating Officer (COO) to manage company operations. The CFO takes a global view of the organization, handling financial and strategic planning issues, while his or her staff (including the controller) manages the daily financial operations. The closest equivalent Arizona has to a CFO is the State's General Accountant who, as keeper of all funds, more closely resembles the private sector's controller. Specifically, Arizona lacks an individual whose primary role is to provide sound financial information to the budget offices and other financial entities to assist with such policy questions as:

- Can we afford a tax cut?;
- How much revenue must we collect to pay for education reform?; and
- Will there be adequate resources in the future to fulfill bond obligations?

This void has put the State in a reactive position regarding the stewardship of public monies and financial management in general.

Arizona's Current Organizational Structure Is Not Conducive to Strong Financial Management

The DOA's current structure is inadequate to handle the financial challenges facing the State. Although Arizona's need for strong financial management is increasing, it continues to place responsibility for its finances at a much lower organizational level than the private sector. As a result, important financial activities are difficult to accomplish.

The need for strong financial management is increasing — Several factors illustrate the increasing need for strong financial management. First, over the past five years, Arizona has experienced rapid budgetary growth. According to the Comprehensive Annual Financial Report (CAFR), the State's general fund revenue has increased by almost 70 percent (from $4.2 billion to $7.1 billion) in the last five years.

Second, stricter professional standards, promulgated by the Governmental Accounting Standards Board (GASB) and the Single Audit Act, have been instituted since the mid-1980s that require greater disclosure of financial information. The State has been unable to meet several of these reporting requirements including financial disclosure of federal grant information and general fixed assets. The inability to meet such standards could ultimately result in the State receiving a lower Certificate of Participation (COP) rating, and thereby paying a higher interest rate to the State's investors.[1]

Lastly, state and national initiatives such as the National Performance Review and the Arizona Budget Reform Act illustrate the increasing demand for greater efficiency and accountability in government.[2] Strong financial management will increase the likelihood that such goals are achieved by providing agencies with the financial data needed to make sound fiscal decisions.

DOA's current organizational structure impedes strong financial management — The DOA's current organizational structure suggests that strong financial management is not a priority, thus leaving Arizona in a reactive position regarding financial management and strategic planning. The current financial management team consists of the Director of DOA, the Assistant Director of the Financial Services Division (FSD), and the General Accountant (who is located in the General Accounting Office). According to A.R.S. §41-732, ultimate responsibility to keep public accounts rests with the Director. However, this statute enables him to delegate the duties associated with this task to the General Accountant of the State. Figure 1 (see page 21) provides a comparison of the DOA's organization structure with that of a typical large corporation.

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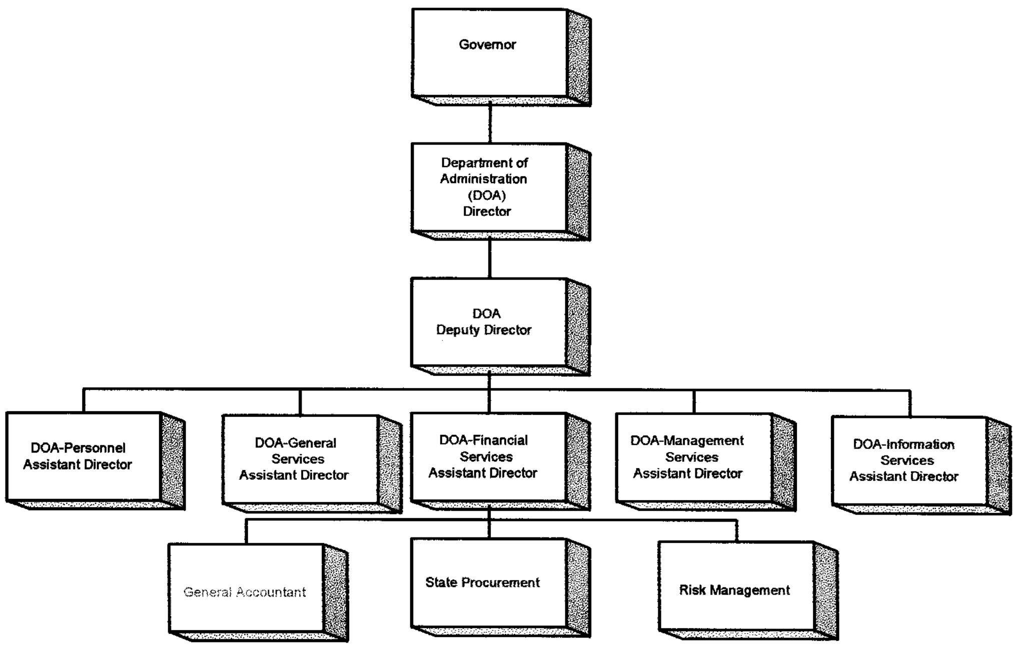
(1) COPs are a legalized form of debt issued as a mechanism to finance the construction or acquisition of state facilities.

(2) The National Performance Review is an initiative by the Clinton Administration to make government "work better and cost less." The Budget Reform Act was passed in fiscal year 1993 by the Legislature to move toward performance-based budgeting.

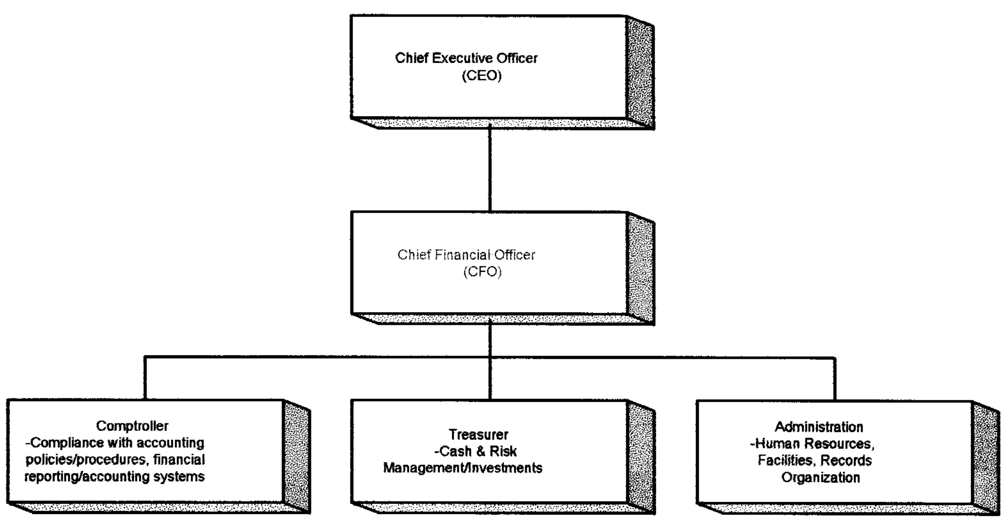
Figure 1

Comparison of Financial Management Structures
State of Arizona vs. Fortune 500 Company

State of Arizona



Fortune 500 Company



As illustrated on page 21, executive leadership over statewide financial matters resides at a much lower level within state government than within the private sector.[1] Not only is the General Accountant four levels below the Governor, but the director and assistant director positions above it are appointed. Consequently, individuals in those positions are not necessarily required to have a financial background.[2] Furthermore, both positions experience significant turnover. For example, in the past five years, there have been five directors and four assistant directors. Lastly, because financial management is one of many responsibilities assigned to the Director, it often competes with other agency priorities. (The DOA has four other divisions in addition to Financial Services. See Figure 1 on page 21.)

Lack of authority makes important financial activities difficult — Although the statute enables the Director to delegate the duties associated with keeping public accounts, the General Accountant has not been given the authority to fulfill important financial responsibilities. Currently, the General Accountant is responsible for, among other things, managing the State's daily financial operations, maintaining the statewide accounting system, and ensuring compliance with accounting policies and procedures. However, the General Accountant lacks the authority to adequately perform these functions and to serve as an equal participant with agency heads on financial matters. For example:

- Agencies continually fail to submit the financial information necessary to prepare the State's Comprehensive Annual Financial Report (CAFR) in a timely manner despite requests from the General Accountant.[3] These delays ultimately contribute to the untimely production of the CAFR. The CAFR, which reports the status of the State's finances, has been late every year since its inception (in 1989) except this past year. The CAFR became a priority this last year when the DOA Director was informed that Arizona was ranked as one of the bottom five states for timeliness of financial reporting.

- When USAS was purchased, it included a procurement module that was subsequently abandoned for another project described as "less effective." Our review indicates that the decision to abandon the original module was made without the support or the participation of the General Accounting Office (GAO) which is responsible for the operation of USAS. The purchasing module is critical to the success of USAS because without it, the system reports misleading information (see Finding II, pages 11 through 17).

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(1) The CFO in the private sector reports directly to the CEO of the company.

(2) The desired qualifications specified in the most recent recruitment for the DOA Director did not include any reference to a financial background.

(3) The GAO must request this information annually from agencies because it is either not on the statewide system, or it is not in the proper format.

- According to several persons involved in implementing USAS, the GAO expressed concerns regarding the insufficient resources dedicated to the project. Having participated in the implementation of the previous accounting system, there was a concern that similar mistakes were being repeated with the new system. Despite these concerns, the DOA decided that the development of USAS had to be within the existing resources. Therefore, no additional funding was provided for such items as training.

In addition, to promulgate new accounting policies and procedures for the State, the General Accountant must first have the support of the Assistant Director and the Director who, as previously mentioned, may not have a financial background.

Government Is Following the Private Sector's Lead

To elevate the importance of financial management and fiscal policy decisions, Arizona should establish a Chief Financial Officer position. National and state trends indicate that strong financial management is becoming a priority in government. If a CFO position is established in Arizona, it should be given statewide financial duties and be structured to withstand the changing political environment commonly experienced in the public sector.

National trends — The federal government has shown its commitment to financial management and accountability through The Chief Financial Officers Act of 1990. This act gave the Office of Management and Budget (OMB) broad new authority and responsibility for directing federal financial management, modernizing the federal government's accounting systems, and improving financial reporting. Citing problems similar to Arizona's, the federal government stated that this act was needed because the existing financial practices did not provide adequate information to plan for current and future operating costs (such as future cash needs), or operate programs efficiently. The act prescribed the establishment of critical financial positions (all of whom are appointed by the President and confirmed by the Senate) including:

- **Deputy Director for Management** — This individual serves as the federal government's CFO. He/she sets universal financial management policies, monitors the resources required to effectively operate, maintain, and enhance financial management systems, and monitors the financial execution of the budget. In addition, the Deputy Director oversees information and procurement policy, property management, and productivity improvement.

- **Comptroller**[1] — The comptroller heads the new Office of Federal Financial Management in OMB. As in the private sector, this individual handles day-to-day accounting operations to ensure universal compliance with financial policies and procedures.

- **Chief Financial Officers** — CFO's were established in 23 major agencies. These individuals establish financial management and internal control policies, establish adequate financial systems to produce useful, reliable, and timely financial data, and integrate budget execution and accounting functions.

The federal government claims that the improved central coordination of internal controls and financial accounting resulting from this act could significantly decrease the billions of dollars lost through waste, fraud, abuse, and mismanagement of programs. One agency CFO stated that he has been able to accomplish important financial activities since the act's passage. The Assistant to the Chief Financial Officer of the Department of Commerce stated that this act is enabling the department to implement a comprehensive financial management system. The Assistant also noted that because the Secretary of Commerce has many other priorities, having a CFO has enabled them to provide more accurate and meaningful information to managers and policy makers. Because accurate financial data is the CFO's primary responsibility, accountability has also improved.

State level — Events at the state level also suggest that strong financial management has become a priority. We conducted a survey of states to gather information on their financial structures.[2] The term "chief financial officer" is not commonly used at the state level. However, strong comptrollers serve in a similar capacity to CFO's in the private sector. Out of the nine states we contacted, five had elevated or created a comptroller position since the 1980s in an effort to prioritize financial management. Two of these five are strong comptroller positions.[3] The need for strong financial management and the results such management can achieve are illustrated below:

- The Governor's Commission on Quality and Efficiency in the State of Kentucky recommended the establishment of a comptroller position to elevate financial management. Several reasons supporting the position were presented to the Commission.

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(1) The terms "comptroller" and "controller" are often used interchangeably. However, the term controller is more commonly used in the private sector.

(2) The National Association of State Auditors, Comptrollers and Treasurers (NASACT) provided us with comptroller information they had obtained from a survey. We used this information to select other states. Our selection was based on the type of appointment (i.e., elected, appointed, civil service exam) and the reporting structure.

(3) According to literature provided by the State of Kentucky (who elevated their comptroller position in 1993), approximately 15 states have a "strong comptrollership function."

They included the lack of a strong, independent, and credible source to assist agencies with internal controls and the inability to report financial data accurately. Also cited was the fact that the current organizational structure was not conducive to attracting the skilled, technical employees needed to manage a large, complex financial management system.

- North Carolina established a strong comptroller position in 1986 that oversees not only financial management activities but information resource management as well. This State's comptroller reports that strong financial leadership has resulted in better financial accountability and reporting, and the successful implementation of a statewide accounting system. The comptroller explained that prior to 1986, financial management was so poor that the budget office had to conduct an agency survey whenever the Legislature wanted specific information on expenditures.

- Massachusetts also implemented a statewide accounting system under a strong comptroller. The system is truly comprehensive (every agency is on line) and provides immediate financial information such as cash on hand to state agencies and statewide officials. Unlike USAS, this system maintains the data needed to produce the Comprehensive Annual Financial Report (CAFR). As a result, the resources and time needed to produce the report are significantly reduced. According to the state comptroller, there are five professionals that work one "intensive" month to prepare the report. In contrast, Arizona has 11 people who dedicate much of the year to the project.

A CFO in the public sector requires authority, independence, and longevity — To withstand the political instability commonly experienced in the public sector, a CFO should have adequate authority, independence, and longevity. Information obtained from both the private and public sectors indicates that an adequate level of authority for the Chief Financial Officer (or equivalent) is critical for the position. According to a management consulting firm, CFOs in Fortune 500 companies always report to the Chief Executive Officer (CEO) and have authority that spans across division lines. The federal CFO Act also emphasized the need for adequate authority. For example, the OMB required that agencies illustrate through an organizational chart that the CFO reports directly to the agency head. The OMB also stated the CFO should have responsibility for information resource management (IRM), or be a full participant in agency-wide IRM decisions, and be able to appeal to the agency head on IRM decisions affecting financial management of which the CFO disapproves.

Stability and independence from the political process are also important. To address these concerns, North Carolina established a comptroller position that serves a seven-year term and reports to both the Governor and the Legislature.[1]

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[1] This position is appointed by the Governor and confirmed by the Legislature.

If the State establishes a CFO reporting to its highest executive, it may require the creation of a new financial management office to support the CFO position. All statewide financial duties currently performed by the DOA should be transferred to this office.

Other considerations — While the establishment of a Chief Financial Officer is an important step toward the improvement of overall state financial management, there may be other elements in the State's financial arena that may also need to be considered. As mentioned earlier, a role of the CFO would be to provide sound financial information to budget offices and other financial entities to assist with policy questions. As this scenario suggests, the CFO would frequently work in conjunction with other state budgeting and financial officers, such as the Joint Legislative Budget Committee, the Office of Management and Budget, the State Treasurer, and the Department of Revenue. Therefore, further study would be needed to determine how these entities would interact or whether any of their roles or functions should be combined or consolidated with the CFO to ensure improvement of Arizona's financial management.

RECOMMENDATIONS

1. The Legislature should consider establishing a Chief Financial Officer (CFO) position. The CFO should be given the statewide financial duties that are presently associated with the DOA. Consideration should also be given to structuring this position with adequate authority, independence, and longevity.

2. If a CFO position is established, the Legislature should also consider further study of the need for interaction between the CFO and other financial officers and whether any of their roles and functions should be combined or consolidated.

FINDING IV

RISK MANAGEMENT'S PROPERTY AND LIABILITY CLAIMS UNIT EXHIBITS NUMEROUS PROBLEMS

Throughout 1994, the State's risk management program experienced various management problems. For example, there were high vacancies (up to 30 percent) at both the staff and supervisory level and a high rate of management turnover – 3 risk managers within a 10-month period. In addition, there were at least five investigations that resulted in four employees being placed on administrative leave, as many as four contracts not being renewed, and an independent adjuster being indicted for fraud.

These disruptions to the Risk Management Section's (RMS) daily operations have undermined the Property and Liability Claims Unit's integrity. An array of claims-handling problems limit the RMS' ability to safeguard monies set aside for the property and liability program. Many of these conditions can be attributed to management's failure to resolve basic problems within their control. Fundamental changes are needed to ensure state monies are well spent and loss exposure is controlled.

Claims-Handling Problems Can Result in Unnecessary Expenditures

The RMS' claims-handling methods expose the State to increased claims settlement costs, inappropriate expenditures, and the potential for fraud. Our review of property and liability claims files found that the majority of these files exhibit at least one fundamental problem. Claims-handling problems identified include inattention, poor documentation, lack of supervision, high caseloads, and weak internal controls.

File review uncovers numerous problems – Numerous claims-handling problems exist in the RMS' property and liability section.(1) To help assess the adequacy of the RMS' claims-handling methods, we reviewed 77 property and liability claims files (49 of these

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(1) The RMS' property and liability section receives over 6,000 claims per year. Claims are filed by state agencies and the public. The claims received vary widely in terms of type and severity – everything from broken windshields on state vehicles, to prisoner lawsuits and environmental claims.

files were open and 28 were closed).[1] Over 80 percent of the files from the sample exhibited at least one problem. Moreover, several problems such as inaccurate claims information on the RMS' automated system, duplicate files, and files that the RMS was unable to locate made the selection and review of the sample difficult and further raised concerns about the extent to which problems exist.

Though individually the problems we identified in our review may not appear significant, when combined they indicate the poor quality of the RMS' claims-handling process.

Inattention and delays in handling – Our review suggests that the RMS has no way of ensuring that property and liability cases are properly adjusted. For example, 17 (35 percent) of the 49 open cases contained no evidence of being adjusted, some being unattended for periods from several months up to 4 years. The RMS attributes some of these delays to not having the appropriate mechanisms in place to integrate outside adjuster cases back into its own workload when contracts expire or are terminated.[2] In December 1994, the contract adjuster assigned to handle the medical malpractice claims was indicted on six counts of fraud and theft for falsifying claims documents relating to his contracted work with the RMS. It was not until 6 months after this indictment that the RMS began reassigning approximately 64 claims to staff adjusters. Similarly, the RMS has yet to reassign an estimated 64 claims that were previously handled by another independent adjusting company, essentially leaving the files unattended in boxes for more than 13 months.

Our interviews with industry representatives indicate that the longer a case remains open, the greater the costs will be to settle the claim.

Poor documentation – In addition, more than 50 percent of all reviewed cases lacked adequate documentation. Since the claims process involves investigating and gathering of documents to determine the State's liability, files should contain an array of documentation. However, we found insufficient documentation to support many claims adjusting activities. For example, cases lacked explanations for the settlement amount or why a case

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(1) We chose a judgmental sample from a March 31, 1995, case summary report, with the intent of reviewing claims at various stages in the process. These files included both in-house adjusters and contracted adjustment services provided by independent adjusters. Because some of the information on the RMS' automated claims management system (Risk Management Information System "RMIS") is inaccurate, we selected alternate files when necessary.

(2) The RMS contracts with independent adjusters to provide specialized knowledge, handle claims in remote locations, and assist with peak workloads. They perform such services as appraisals, taking accident scene photos, and interviewing claimants. The cost for these services typically range from $35 to $49 per hour. In contrast, the RMS staff adjusters' salaries range from $12 to $18 per hour (excluding benefits and overhead).

was denied, evidence of the claimant's signed release, and adequate documentation to support the payments made to outside adjusters and legal counsel.[1]

Inadequate documentation can expose the State to future liabilities and cannot ensure that expenditures are necessary or appropriate. For example, an independent adjuster was hired to provide interim adjusting services for medical malpractice claims. A $12,430 bill was submitted and paid, representing two months' work (individual billings ranged from $307 to $959 per claim file). However, we were unable to find adequate support for these billings, especially since we discovered some cases were essentially closed by the previous adjuster and others contained no documentation to support that any work was performed by the interim adjuster.

Lack of supervision — In addition to cases not being adjusted in a timely manner or properly documented, they are not receiving the necessary supervisory review. The RMS claims staff and supervisors report, and our file review confirms, that virtually no supervisory review takes place from the time a case is assigned until it is closed. This lack of supervision applies to both the RMS' in-house adjusters as well as the independent adjusters. Most files contained no documentation indicating that a supervisor had ever reviewed the case. Moreover, 13 of 18 (72 percent) case assignments to independent adjusters we reviewed did not receive the necessary supervisory approval.

The lack of supervisory review can ultimately result in inappropriate and unnecessary expenditures. For example, we identified several cases that appeared to result in unnecessary costs:

- A claim for a $200,000 embezzlement loss remained only partially resolved over an 18-month period because the RMS failed to initiate claims processing with its insurance company.[2] There was no evidence of supervisory review during the 18 months. The State now risks losing reimbursement of $100,000 from its insurance company because of the negligent handling of this case.

- An unapproved assignment for independent adjusting resulted in payment of $635 to perform work over the phone and by mail; tasks which could have easily been done by the RMS adjusters for considerably less cost. Payment on this case was made to two separate adjusters, and there was no documentation in the file to support either payment.

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(1) A signed release form is used to preclude future State liability when a claimant is paid. However, the RMS has not developed adequate policies and procedures to ensure that signed release forms are appropriately obtained.

(2) The State is primarily self-insured. However, when it is available and affordable, the State purchases insurance from private carriers. In this case, the State has a policy that covers losses in excess of $100,000.

- A local independent firm was paid to photocopy investigative materials for 21 hours, charging $44 per hour, costing over $900. Similarly, another local independent adjuster was paid, at a rate of $35 per hour, nearly $1,000 for 28 hours of photocopying materials.

High caseloads — High caseloads also impact the quality with which claims are handled. Industry experts we interviewed indicated that there are no industry standards for optimal caseload size because each risk management program has its own unique set of circumstances. Such factors as the types of claims, whether deductibles are in effect, the deductible amounts, and seasonal fluctuations can affect optimal caseload size. Therefore, if caseload guidelines are used, each individual entity has to develop its own caseload standards based on the particular nature of claims and liability.

In 1990 the RMS developed adjuster workload standards. To develop these standards, the RMS reviewed information from the private sector, considered the type and complexity of cases handled by the State, and estimated the average number of hours needed to adjust particular cases. However, since 1990 the RMS has not revised its workload standards, and for at least the past year the RMS adjusters have been operating with caseloads more than double the RMS' standard of 120 to 140. For example, an analysis of the Phoenix property and liability claims adjuster caseloads for May 1995 revealed caseloads averaging 270 cases per adjuster with one caseload of 491.(1)

Operating with high caseloads may result in less thorough investigations. This in turn may result in some cases being settled for less than if they were given more attention. Similarly, heavy workloads may result in fraudulent claims going undetected, since adjusters can treat most cases in only a superficial manner.

Weak internal controls — Claims-handling problems also exist during the payment processing stage, whereby weak internal controls expose the State to inappropriate expenditures or even fraud. We found that despite a previous review from our Office citing the RMS for employing inadequate segregation of duties, this problem had not been corrected when our performance review began.(2) For example, each accounting clerk was allowed to input claims data, release transactions for processing, and receive the warrants (i.e., checks).(3)

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(1) One staff person has a caseload of 815. However, the RMS officials contend this person handles primarily small dollar property claims from Department of Corrections inmates and it is appropriate to carry such a high caseload. This person's caseload was not figured in the average.

(2) The problem was identified in our Fiscal Year 1993 Management Letter Report which is separately issued to the agency. This Letter Report is issued in conjunction with the statewide single audit.

(3) It was not until May 1995 that the RMS began segregating these duties.

Weaknesses in payment procedures further jeopardized the RMS' ability to safeguard monies. Ideally, when a claim payment is processed it should include adequate taxpayer identification information, such as a social security number, to enable the State to adequately track the financial transaction. However, a February 1995 analysis by the RMS accounting staff found that 21 percent of all payments processed during that month did not contain this crucial identification information. Without this information simple error detection becomes difficult and fraud detection nearly impossible. For example, we found one case where the RMS' automated system indicated two payments were sent to a claimant, though the claim file contains a copy of only one payment. The RMS was unaware of the possibility that a duplicate payment occurred for this case. Moreover, when we tried to verify whether a duplicate payment was made, the RMS explained that difficulties in reconciling the RMS' automated system with the statewide accounting system severely limits their ability to determine if and when duplicate payment actually occurs.

In August 1995, subsequent to the end of our review, the GAO established a policy restricting the use of the transaction code that allowed payments to be processed without adequate taxpayer identification. The RMS furthered the intent of this policy by eliminating the accounting staff's access to that code.

The RMS Failed to Address Deficiencies

The RMS has been remiss in addressing the deficiencies its program exhibits. The RMS has not maintained or utilized essential management information. Further, it has not adhered to established policies and procedures, and has not managed its contracts. Finally, various staffing problems have contributed to the disorder of the claims management function.

Failure to use management information — The RMS has failed to fully utilize much of its management information to adequately oversee its operations. The Risk Management Information System (RMIS) contains information pertaining to case assignment and status, financial payment histories, and the use of outside adjusting services and counsel. The RMIS provides regular reports to adjusters and management that can be used as a tool to manage claims, gauge performance, and portray workload. However, our review indicates the data is inaccurate in many instances. For example, the RMS continues to show cases assigned to an independent adjuster who was indicted, a contractor whose contract has expired, and to the category "unknown."

The RMIS also fails to capture additional data that could assist the RMS in managing its claims operation. For example, the RMS is currently unable to determine the frequency and reasons for using outside adjusting services.[1]

Failure to follow policies on supervision — In addition, although the RMS has established explicit policies and procedures regarding supervision, they essentially are not in effect. For example, supervisors are required to review at least 20 cases from each adjuster on a monthly basis. Despite this requirement, as illustrated earlier most cases are not receiving any type of supervisory review. Further, supervisors are also required to conduct an annual review of the adjusters' work. However, the RMS staff state that these ongoing monthly reviews have been neglected and annual reviews have not been conducted for at least the past two years due primarily to time constraints.

The RMS attributes its failure to follow policies to turnover among upper management, and the attention management has had to give to several investigations and management projects over the past two years.

Poor contract management — Further, despite spending $1.7 million for contracted adjusting services during the past two years, the RMS has failed to properly manage these contracts. For example, within the past 18 months, the RMS has encountered the following problems:

- Over a ten-month period, the RMS allowed staff adjusters to assign over $95,000 worth of adjusting work to an independent company before discovering the company's contract had expired and had not been reawarded during the previous rebidding process.

- The RMS management hired a consultant at the cost of $43,000 to investigate an independent firm suspected of overbilling for its services. Though the RMS management ordered the independent firm to cease state contract work during the investigation, our file review indicates that the RMS staff continued to send them work while the investigation was underway.

- The RMS has not developed specific policies regarding contract management, including policies on potential conflicts of interest. For example, we found two employees were granted authorization to perform adjusting services with independent adjusting firms that held state contracts. Because these employees are in a position to assign cases out to their secondary employer, the RMS cannot ensure that cases are being sent out judiciously and in the State's best interest.

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[1] Subsequent to the completion of our fieldwork, the RMS began compiling some data on the use of outside adjusting services.

Staffing problems — Finally, staffing problems, including extended vacancies and high turnover, have further contributed to the disorder of the claims management function. For example, while the vacancy rate office-wide is relatively high (21 percent), the number of vacancies within the property and liability unit is even higher (30 percent). In addition, the majority of these vacancies have remained open for over nine months. According to the RMS officials, these positions have not been filled for various reasons including the RMS' involvement in several ongoing investigations and the organizational "turmoil" resulting from such disruptions. Moreover, four employees (including two managers and a supervisor) had been placed on paid administrative leave during the various investigations previously mentioned, stifling the RMS' ability to fill certain positions.

The RMS has also had three different risk managers within a ten-month period, which may have impacted its ability to make improvements in its operations.

Immediate Action Is Needed to Improve Claims Management

Although the RMS claims management function suffers from numerous problems, many of these can easily be resolved by following good claims management practices.

First, the RMS should follow its established policies and procedures. For example, the RMS should regularly employ the supervisory activities it has already established and that are common among other public risk management entities. Public risk managers that we interviewed report that well-run claims operations require hands-on supervision, constant monitoring of outside adjusting services, and routine audits (i.e., bi-monthly, annual, etc.). Most of these items are already addressed in the RMS manual and should be followed. In fact, following the completion of our review, the RMS officials have indicated they are re-establishing the continuous supervisory reviews. To help in this process, the RMS has developed a supervisory checklist and plans to review 20 cases per month, per adjuster.

Second, the RMS will need to determine what additional policies need to be developed. For example, the RMS has a need for outside adjusting services yet lacks the necessary guidelines to adequately oversee this process. Specifically, it needs to establish formal procedures for case assignment, monitoring, billing documentation, and review. Public risk managers that we spoke to stressed that oversight and supervision of contracted adjusting staff is just as important as it is for in-house staff. Therefore, guidelines must be established that specify assignment procedures, performance expectations, review and audit mechanisms, and effective billing practices.

Finally, to enhance its ability to perform effectively and control costs, the RMS needs to address deficiencies in its management information system. A first step in doing this would be to conduct a thorough review of its caseload inventory and identify cases that need closure. From there, the RMS could assess and prioritize its caseload. In addition, the RMS should consider if additional management information should be captured. Presently, the automated system does not provide adequate management information to make workload decisions or determine the appropriateness of certain expenditures. For instance, an analysis of the cost per claim could assist the RMS in determining the need or cost effectiveness of increasing either in-house staff or the use of outside adjusting services.

RECOMMENDATIONS

1. The RMS needs to immediately implement or reintroduce basic claims management techniques to ensure the effective and efficient operation of its program by:

   - Requiring regular supervision of all adjusters, both in-house and contract, as well as conducting continuous and annual reviews;
   - Revising its caseload standards so they can be used to help assess adjusters' workloads;
   - Addressing current internal control weaknesses by employing adequate segregation of duties, and improving error detection capabilities; and
   - Establishing guidelines and procedures for the assignment and monitoring of outside claims adjusting services.

2. The RMS should assess the adequacy of its case management system by:

   - Performing a thorough analysis of RMIS, determining the reliability and accuracy of claims data; and
   - Determining what additional management information is important to capture.

3. The RMS should actively pursue filling vacant positions.

FINDING V

THE RMS NEEDS TO PROVIDE AGENCIES WITH STRONGER INCENTIVES TO CONTROL LOSSES

The RMS should give agencies stronger incentives to control losses. While the Risk Management Section (RMS) administers loss control programs designed to assist agencies in reducing exposure to loss, agencies currently have no strong financial incentive to elevate their loss prevention efforts. Similar to risk management programs in other state and governmental entities, the RMS should implement additional mechanisms to increase agency efforts at loss control and prevention.

Programs Designed to Assist Agencies in Reducing Losses

Because loss control and prevention are integral parts of any risk management program, the RMS has established programs designed to assist agencies in their efforts to control the frequency and/or severity of their losses. The RMS' loss control programs include, among other items, safety and loss prevention training, telephone and on-site consultations, and loss control grants. The RMS employs occupational safety consultants, industrial hygienists, environmental specialists, and training officers to provide these programs. However, the services and programs provided by the RMS are not mandatory, and not all agencies have taken advantage of them.

No Financial Incentives to Increase Loss Prevention Efforts

Currently, there are no strong financial incentives to encourage loss control behavior at the agency level. Although the RMS charges agencies for insurance costs, its model for allocating costs has been ineffective. Further, the budgetary process also provides little or no link to loss control behavior.

The RMS' cost allocation model has been ineffective — Unlike the optional nature of the RMS' loss control programs, all state agencies must financially contribute to the cost of insuring against losses. To give each state agency the financial incentive to control its losses, the amount each agency contributes to the cost of insurance should be linked to its loss history (i.e., how many losses it incurs) and its potential for loss (i.e., its loss exposure such as the number of employees). Although the RMS utilizes an actuarial formula (known as the cost allocation model) to arrive at agencies' insurance costs, it appears this formula has not been effective in establishing the necessary financial incentive. For example, the dollar amount some agencies have been charged for insurance appears to have fluctuated dramatically in the past, sometimes for no apparent reason. The RMS indicates that these fluctuations were due in part to changes in actuarial assumptions and in part to the cost allocation model's failure to reflect actual loss experience because the formula was old, complicated, and prone to errors. Nevertheless, from an agency perspective, these dramatic fluctuations can cause an agency to conclude there is no relationship between its loss behavior and its insurance costs. This is especially true because the cost allocation model was so complicated that the RMS staff could not explain to an agency why insurance costs change.

To address these problems, during fiscal year 1995, the RMS requested its actuary to develop a new cost allocation model. The revision to the model was a joint effort between the RMS and both budget offices — the Joint Legislative Budget Committee and the Governor's Office of Strategic Planning and Budgeting. The revised plan has the overall goals of achieving more stable, simplistic, and responsive insurance costs and helping to encourage loss control by linking insurance charges to actual loss experience and exposure to loss. Thus, given no change in loss exposure, when actual losses decrease the agency charge will decrease and when losses increase the agency charge will rise. However, because the plan is new, we were unable to assess its effectiveness in achieving these goals.

Budgetary process provides little incentive — Regardless of the new cost allocation model's success, the current method for budgeting for agency insurance costs provides little or no link to loss control behavior. Once an agency's insurance costs are determined, these costs are included as part of its other operating expenditures which are appropriated by the Legislature. If an agency experiences an increase in its insurance costs (even a dramatic one) due to poor loss behavior, it is not necessarily reflected by a reduction in the subsequent year's operating budget. In other words, as insurance costs increase, so does the legislative appropriation to cover the new insurance charge. As a result, an agency is not likely to feel the financial ramifications of poor loss behavior, or the benefits of good loss behavior. According to legislative budget staff, the current techniques may not give agencies as much incentive to control losses as other techniques because their "operating base" is not usually directly affected by their loss behavior.

Additional Tools Are Needed to Encourage Loss Control Behavior

The RMS may need to implement additional techniques to strengthen agencies' willingness to prevent and reduce loss costs and exposures. The RMS has attempted, unsuccessfully, to provide incentives for agencies to control losses. Therefore, it should consider implementing additional techniques found in other risk management programs, such as deductibles and premium credits.

Previous incentive attempts — The RMS' attempt to establish a stronger relationship between an agency's insurance costs and loss behavior has been ineffective. The State established a $100 deductible for property claims in 1989. However, this tool is ineffective in influencing agency loss behavior for two reasons: 1) the deductible amount is too low, and 2) it is a "disappearing" deductible. Under this disappearing deductible, the agency covers any property losses up to $100. When a loss exceeds $100 (even $101), the deductible disappears and the RMS pays for the entire claim.

True deductibles and premium credits should be considered — The RMS may need to implement additional techniques to increase agencies' willingness to participate in loss prevention measures. For example, we contacted 15 states, the City of Phoenix, and the City of Scottsdale, and found that the use of deductibles and premium credits is fairly common:[1]

- **Deductibles** — When a "true" deductible is in place, an agency must pay for a certain amount of each loss. For example, with a $500 property claim deductible, an agency would pay for the first $500 of each property loss. Nine out of the 15 states we contacted use some form of deductibles for property, workers' compensation, and/or liability losses. For example, Nevada, Utah, and Oregon impose a $500 to $1,000 deductible on property claims. Also, according to a RMS official, seven city and two county programs in Arizona use property claim deductibles.

- **Credits** — A premium credit rewards an agency's loss control efforts. If there is a credit in place, an agency gets a reduction on the insurance premium they must pay. An example of a premium credit in the private sector is a good driver or good student discount whereby the individual's premium is reduced by a percentage, such as 5 percent. Six of the 15 states we contacted use premium reductions, premium credits, or recognition awards as incentives. For example, Utah agencies that meet all the safety criteria established by its risk management program receive a credit toward their premium for the next year. Likewise, Louisiana agencies receive a 5 percent premium reduction if they are safety certified in all areas.

These and similar deductibles and credits have been used by other risk management programs for years, some since the inception of their programs. Other state risk management officials acknowledged that deductibles do provide an incentive for agencies to

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[1] The 15 states (Alabama, Colorado, Florida, Georgia, Louisiana, Missouri, Montana, Nebraska, Nevada, North Carolina, Oregon, South Dakota, Utah, Vermont, and Virginia) were chosen based on similarities with Arizona's risk management program. For example, we looked at the type of insurance offered, type of services provided, and type of functions performed.

control costs. Additionally, one state official commented that the use of deductibles seemed natural since they are customary business practice for private insurance companies. Further, deductibles can have the added benefit of reducing the number of small claims and their administrative costs. As one state official noted, deductibles eliminate the need to expand their claims department and allow them to concentrate on the bigger, more important claims.

Implementation of either a deductible or premium credit appears reasonable for Arizona's risk management program. Our review indicates agencies are fairly receptive to the idea of a deductible. In fact, the RMS has been contemplating increasing the use of deductibles for quite some time. In January 1994, the RMS, along with agency representatives, researched the idea of increasing the deductible to help promote loss control. While this effort was put on hold, the RMS plans to address this issue in the near future. Increasing the amount of the deductible, or implementing premium credits, would require a change in the DOA's Administrative Rules. Under R2-10-106 the RMS has authority for only a $100 deductible.

RECOMMENDATIONS

1. The RMS should ensure its new cost allocation model encourages loss control behavior by linking insurance charges to actual loss experience and exposure.

2. The RMS should consider increasing the deductible and implementing premium credits to help increase agencies' efforts to control loss costs and exposures.

AREA FOR FURTHER AUDIT WORK

During the course of our audit, we identified an area for further audit work that we did not pursue due to time limitations.

Does the State Procurement Office (SPO) adequately facilitate statewide purchases of goods and services?

At the time of our audit, the SPO had recently completed a comprehensive review of its operations. This project, referred to as business process reengineering (BPR), was a collaborative effort for which the SPO sought input and assistance from other state agency, local government, and private sector representatives. This project employed multiple techniques such as surveys, focus groups, brainstorming sessions, and site visits to determine whether the SPO was meeting the needs of its customers. The recommendations proposed in the report, if fully implemented, are expected to fundamentally change the State's procurement operation. However, at the time of our review this BPR study was in draft form. Subsequent to completion of fieldwork, the Director determined that additional analysis was needed. Further audit work is needed to establish the outcome of the BPR study and its impact on the SPO's ability to meet statewide procurement needs.

Agency Response

FIFE SYMINGTON
Governor

RUDY SERINO
Director

ARIZONA DEPARTMENT OF ADMINISTRATION

OFFICE OF THE DIRECTOR

1700 WEST WASHINGTON • ROOM 601
PHOENIX, ARIZONA 85007

(602) 542-1500

November 6, 1995

Mr. Douglas Norton
Auditor General
2910 N. 44th Street, Ste. 410
Phoenix, AZ 85018

Dear Mr. Norton:

Attached are the agency responses regarding the performance audit of the Financial Services Division.

If you have any questions regarding these comments, please call Mr. John Timko at 542-0500.

Sincerely,

Rudy Serino
Director

RS:JT:wh

Attachment

CC: John Timko

Finding I - The Integrity of the State's Financial Information Remains at Risk.

Recommendations:

1. **The GAO should take measures to improve the internal control structure of the State by:**

   a. **Assuming data entry responsibilities of those agencies unable to implement proper internal controls due to limited staff; and**

<u>Response:</u>

Concur. Historically, the ADOA-GAO has provided such assistance to agencies to the extent possible. The Department is always willing to assist agencies with any difficulty they may have as long as there are resources available to provide the assistance. We concur that adequate resources should be provided to properly fulfill the Auditor General recommendations.

   b. **Revoking access to those agencies that repeatedly violate internal control policies.**

<u>Response:</u>

Concur. The ADOA concurs with the recommendation, however, this is a very drastic step which is taken only after all other avenues of corrective measures have been explored. This is done at the time when it becomes in the best interest of the state to revoke access. The ADOA-GAO has revoked access in the past and will continue to do so as necessary.

2. **The GAO, after consulting with the affected agencies, should consider restricting system access based on agency needs to facilitate system interaction and reduce the possibility of financial inaccuracies.**

<u>Response:</u>

Concur. The ADOA concurs with the recommendation and feels that the system has those capabilities. The access is controlled through a GAO security review prior to permitting any individual access to the system, through the profiles established by the agencies and the type of transactions authorized for any individual, and through periodic system reviews. This process has become more formalized since the implementation of the GAO Security Group.

3. **The GAO should require all users to complete training as a condition of having system access. This training should occur within a specified timeframe from the employee's hire date.**

Response:

Concur. The training requirement prior to allowing system access is reasonable. The establishment of a specific timeframe such as 6 months from hire with the stipulation that access will be terminated unless the individual has attended training would be ideal. We concur that with additional resources, the GAO could schedule a variety of training classes and expand the number of classes that are offered. To date the training group has conducted a variety of classes on AFIS and travel policy which involved 1,162 state employees.

4. **The GAO should ensure its training plan includes a discussion of how the training, internal audit, and systems security groups can coordinate their efforts to best utilize existing resources.**

Response:

Concur. Coordination between the training unit, internal audit and system security is already happening within GAO. There are frequent discussions regarding audit findings and security concerns which are incorporated into the training modules to avoid future problems and improve performance. Additionally, current personnel are utilized as subject matter experts with whom the trainers confer in the development of training modules.

Finding I - General Comments

While the ADOA concurs with all of the recommendations and has already implemented each of the recommendations to the extent possible within its funding constraints, ADOA does not agree with many of the statements and most of the examples cited in this finding.

For example, we disagree with the statement: "The DOA has failed in its obligation to provide an adequate internal control structure for the State, ...". Good internal controls in a decentralized, automated environment requires a combination of automated controls and agency-level segregation of duties. The ADOA controls the "system" security in a variety of ways that are more than adequate UNLESS the agency-level controlled assignment of incompatible duties breaks down. Both the ADOA and the Auditor General have committed significant resources to audit functions which detect and report agency-level internal control weaknesses. It is the responsibility of agency management to correct these problems. In suggesting that ADOA is responsible for the solution to these problems, the Auditor General misses the point. For example, in the June 1994 example of fraud, the employee involved received his access to the system through forged authorization documents.

Likewise, the examples of "inadequate training" are more reflective of complete management breakdowns at the agency level. Both the training and individual assistance required to prevent these problems was available from ADOA if the agency management had simply called and asked for assistance.

Finding II - The Statewide Accounting System Unable to Readily Portray Arizona's Financial Position

Recommendations:

The DOA should take the following steps to improve the statewide accounting system so that it meets it s original expectations and the DOA can fulfill its statutory mandate by:

1. **Conducting feasibility studies to determine if the current billing system and ad hoc reporting tool can be enhanced to meet agency needs or if additional software is necessary.**

Response:

Concur. The ADOA is currently pursuing enhancements to the system encompassing these two areas to provide improved service to its customers and meet the original expectations of the system. Various modifications have been made to the system to improve on-line reporting and we are exploring the feasibility of implementing one of several report writing tools which should fulfill the ad hoc reporting requirements of agencies.

2. **Reprogramming the system to make it more user friendly and efficient.**

Response:

Concur. The ADOA-GAO is continually modifying the system to provide a more user friendly environment for users, however, reprogramming the system totally is not practical or very feasible due to our daily operational requirements.

3. **Integrating the system with procurement activities and address payroll processing delays.**

Response:

Concur. Procurement activities currently interface with the USAS. The procurement system "ASAP" provides USAS with an input tape that has been checked for propriety before submitting to the USAS system. The Department is continuing to pursue improvements to this interface to provide more effective and efficient operation for possible integration of the systems. As to the payroll delays, it is the opinion of the GAO that there are no payroll delays. The payroll is processed through HRMS on Wednesday and then processed to AFIS on Friday the official payday of the State. This processing is the customary and usual processing which is in line with the official payday of the State. Therefore, there are no processing delays between the State payroll system and the State financial system.

4. **Improving the quality and quantity of information on USAS by:**

   a. **Assessing the additional system enhancements required by the three largest state agencies to meet their needs, and as a long-term goal, equipping USAS to fulfill those needs; and**

<u>Response:</u>

Concur. The ADOA is continuously assessing the requirements of the three largest agencies and is constantly trying to meet those needs. As we have in the past, ADOA is working with the agencies and, as a result, five large agencies have substantially eliminated their general ledger systems (Education, Corrections, Juvenile Corrections, Health Services, and Revenue) and are now using USAS as their principal system. However, if the implication in this recommendation is that the three largest agencies should disband their internal systems and use USAS totally, this will not easily happen due to the size and uniqueness of these agencies. To accomplish a total integration of these agencies would take a major statewide cooperative effort and a long-range plan for implementation.

   b. **Ensuring, through better training and specific discussion with agencies that agencies record complete financial information on the USAS system whenever possible.**

<u>Response:</u>

Concur. The recent implementation of AFIS Training has improved the training of agencies. However, additional resources as are recommended would speed the progress being made in the training offered to agencies. The ADOA-GAO will continue to improve and expand this new program as resources become available.

5. **Considering converting those agencies that comprise the largest share of the State's revenues and expenditures to GAAP basis accounting.**

<u>Response:</u>

Concur. GAAP basis accounting is more appropriate for financial statement reporting purposes. However, the current budgetary process and statutory requirement is cash basis and, therefore, a total change to GAAP basis accounting requires a statutory change and a re-education of (the legislative and executive branches) government personnel.

Finding II - General Comments

The ADOA concurs with all these recommendations. We also suggest that the dedicated employees involved in this massive project should be congratulated for their success to date, in spite of serious lack of resources. As pointed out in the audit, other states have spent four to twenty times what Arizona has spent in installing their systems. In our user group meetings with these other states, we find that in spite of the funding discrepancy, Arizona's system is on a par, or exceeds the capabilities of these other states.

Finding III - The State Needs a Chief Financial Officer

Recommendation:

1. **The Legislature should consider establishing a Chief Financial Officer (CFO) position. The CFO should be given the statewide financial duties that are presently associated with the DOA. Consideration should also be given to structuring this position with adequate authority, independence, and longevity.**

2. **If a CFO position is established, the Legislature should also consider further study of the need for interaction between the CFO and other financial officers and whether any of their roles and functions should be combined or consolidated.**

Response:

ADOA does not agree that this finding and recommendation is proper in a Performance Audit of the Financial Services Division. It does not deal with our performance and we cannot implement the recommendation. The Auditor General should use a different venue to advance this proposal for a fundamental restructuring of state government's financial system.

The finding fails to make the case for the need for such sweeping changes and also fails to demonstrate that their proposed course of action has had any measurable impact in the states which have tried this approach. However, if the legislature decides to address this recommendation, ADOA will be happy to comment and assist as required.

Finding IV - Risk Management's Property & Liability Claims Unit Plagued with Myriad of Problems.

Recommendations:

1. **The RMS needs to immediately implement or reintroduce basic claims management techniques to ensure the effective and efficient operation of its program by:**

   a. **Requiring regular supervision of all adjusters, both in-house and contract, as well as conducting continuous and annual reviews;**

Response:

Concur. Risk Managements Property and Liability Claims Unit currently has two supervisors and will be hiring a third within the next 30 days. This provides for improved and more complete supervision of 16 in-house adjusters, as well as oversight for the assignments made to outside independent adjusters and private investigators.

Claims supervisors are currently reviewing 20 files per adjuster, per month and an audit review sheet is completed for the file. Annual reviews are conducted on each adjuster at the appropriate annual performance review period.

   b. **Revising its caseload standards so they can be used to help assess adjusters' workloads.**

Response:

Concur. Caseload standards should be reviewed periodically. They are one of several important workload measures used by management to balance adjusters' workloads. Since case volume and complexity vary widely during the year, the judgement of experienced supervisors in caseload assignment is more important than arbitrary standards in assuring proper attention to the claims adjusting process. As of this response, the average caseload per adjuster is 137 cases, within the 120-140 case standard.

   c. **Addressing current internal control weaknesses by employing adequate segregation of duties, and improving error detection capabilities; and**

Response:

Concur. As noted in the footnote to the audit report, the issue relating to segregation of duties has been resolved.

During August of 1995 we have instructed our accounting staff that all claim payments have a taxpayer identification number, unless the payee specifically refuses to furnish us with a taxpayer identification number. During the first part of September 1995, we have instituted a system control that effectively requires a taxpayer identification number in order to process a payment.

d. Establishing guidelines and procedures for the assignment and monitoring of outside claims adjusting services.

Response:

Concur. Presently all independent adjusters' and investigators' work is reviewed by the assigning RM adjuster, with selected follow up review by the supervisor. All independent adjusters' and investigators' billing is reviewed by the claims manager before being submitted to accounting for payment.

2. The RMS should assess the adequacy of its case management system by:

a. Performing a thorough analysis of RMIS, determining the reliability and accuracy of claims data; and

Response:

Concur. There currently is an ongoing analysis of RMIS with regard to its accuracy and reliability. As with any computer system that has been in service for many years, our system is in need of improvement. RM management is presently looking for ways to improve upon or replace the current information system and will continue to do so. The present system has never been purged and we are preparing for a "clean up" of the system to free up more space and allow for additional functions.

We have reconciled AFIS to RMIS as of October 1994. We are currently working on reconciling July 1995, so that we can ensure that the current year is reconciled, and at the same time we are working on reconciling November 1994. All FY 1995 reconciliations will be completed by November 30, 1995, and FY 1996 will be brought current at the same time.

b. Determining what additional management information is important to capture.

Response:

Concur. Our computer consultants are working with our management to determine what additional information, reports, etc. are needed. In FY 1995, 64 Requests for Service improvements were completed by our computer support consultants. These improvements affected our functionality and reliability of both the Workers' Compensations side of RMIS as well as the Property and Liability side. This fiscal year we are working on improvements to our system security as well as the continuous reconciliation of the RMIS to AFIS interface. We currently have 34 Requests for Service actively being worked on by our computer support consultants. Within this fiscal year we will have our RMIS system fully documented and up to date.

3. The RMS should actively pursue filling vacant positions.

Response:

Concur. Beginning June 1, 1995, through the present, six vacancies have been filled in the Property and Liability Unit. There are three additional vacant positions. Hiring lists for these positions are being reviewed and interviews are in process. These remaining vacancies should be filed within 30 days. Of the seven remaining vacancies elsewhere in RMS all are in active stages of being filled. RMS is expected to be fully staffed no later than December 1995.

Finding IV - General Comments

While the ADOA concurs with these recommendations, we strongly disagree with the text of the finding. The first three and one half pages discuss the results of a sample consisting of 77 claim files. The reader needs to search the footnotes to discover that the sample is "judgmental", that is to say it is not statistically valid and that the results of the sample should NOT be used for drawing conclusions beyond these 77 claims or applying these results to the entire population of 6,000 claims per year handled by the claims unit. We feel this report unfairly encourages the reader to do just that. We have expressed our concerns to the Auditor General who has refused to amend the report in this regard.

Finding V -The RMS needs to Provide Agencies with Stronger Incentives to Control Losses

Recommendations:

1. **The RMS should ensure its new cost allocation model encourages loss control behavior by linking insurance charges to actual loss experience and exposure.**

Response:

Concur. The primary purpose of our allocation module is to apportion the total of estimated losses to individual agencies on an equitable basis. However, another one of the goals is to encourage good loss control behavior by linking insurance charges to loss experience and exposure. Our new model achieves these ends and others. It also embodies a structure which is widely regarded in the insurance industry as "best practice."

2. **The RMS should consider increasing the deductible and implementing premium credits to help increase agencies' efforts to control loss costs and exposures.**

Response:

Concur. RMS is currently working on changing our deductible to a "true" deductible and increase the dollar amount in graduated amounts to $1,000.

Additionally, research is being conducted with input from other states already working with a true deductible system.

We are also seeking information on premium credits from states actively using a credit system.

It is anticipated that legislation and rule changes will be brought up this year.

However, it must be noted that RM has been doing some very successful loss prevention program and incentives for the past 4 years. They are:

a. Competitively selecting a Risk Manager/Loss Prevention Coordinator of the year. As incentive we award to the winner conference registration, air fare, hotel and normal travel expenses to the Annual Public Risk Manager Conference, (PRIMA).

b. RM issue one time loss prevention grants to agencies that submit cost effective projects that will improve public & employee safety thus producing a reduction in losses to the state. Approximately $400,000 per year in grants are budgeted for and funded by the legislature.

c. Every quarter RM sponsors and conducts an all day User and Environmental meeting. These meetings convey current changes going on in the risk management field. They normally have a guest speaker and round table discussions of current agency problems. Most large agencies are represented as well as all three universities.

d. We are analyzing the past losses of major agencies and working with them on an individualized basis to install remedial action programs which will help prevent future reoccurrence of incidents which have historically resulted in the most expensive claims against the state.

e. We are redirecting our existing resources to deal more effectively with areas of exposure which present the greatest potential for losses -- eg, liability, employment and environmental claims.

f. Various improvements have bene made in our Workers' Compensation program. They have produced over $1,600,000 in annual cost savings, and have resulted in W.C. being given the prestigious Governor's Award for Excellence.