



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

State of Arizona

Year Ended June 30, 2005



Debra K. Davenport
Auditor General

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**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

June 26, 2006

William Bell, Director
Arizona Department of Administration
100 North 15th Avenue
Phoenix, AZ 85007

Dear Mr. Bell:

In planning and conducting our single audit of the State of Arizona for the year ended June 30, 2005, we performed the following as required by *Government Auditing Standards* (GAS) and Office of Management and Budget (OMB) Circular A-133:

- Considered the Department's internal controls over financial reporting,
- Tested its internal controls over federal programs, and
- Tested its compliance with laws and regulations that could have a direct and material effect on the State's financial statements and federal programs.

Specifically, we performed tests of cash receipts, receivables, cash disbursements, bidding, payables, transfers, payroll, buildings and equipment, financial reporting, the Schedule of Expenditures of Federal Awards, interest liability calculations for the Cash Management Improvement Act, and the Federal Surplus Property Transfer Program.

There are no audit findings that are required to be reported by GAS or OMB Circular A-133. However, our audit disclosed internal control weaknesses and instances of noncompliance with laws and regulations that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls and comply with laws and regulations. Our recommendations are described in the accompanying summary.

This letter is intended solely for the information of the Arizona Department of Administration and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

The Benefits Office should strengthen controls over claims payment processing for the State's self-funded health insurance program

Beginning in fiscal year 2005, the State implemented a self-funded health insurance program for its employees, retirees, and their dependents, and the Department of Administration's Benefits Office is responsible for administering the program. For healthcare claim payments, the Benefits Office contracted with four vendors to process and pay all medical and prescription drug claims for the program. These contractors processed approximately \$485 million in medical and prescription drug claims during the fiscal year. Therefore, it is critical that the Benefits Office require these vendors have an effective system of internal control in place to ensure that claim payments are accurate and appropriate. However, the Benefits Office did not fully accomplish this objective. Specifically, only two of the four vendors received independent audits of their claims processing systems; as the Benefits Office did not include contractual provisions in the vendors' contracts requiring them. Also, the Benefits Office did not review and evaluate the results of these audits. Further, the Benefits Office did not perform its own audit of claims paid because the vendors would not provide the Benefits Office with their fee schedules used for payments to medical providers, and for two of the vendors, the claims data provided was either a voluminous hard copy report, which was unusable, or in an unreadable electronic format. Finally, the Benefits Office did not compare billing statements from the vendors to the supporting claims reports.

To strengthen controls over the medical and prescription drug claims payment process, the Benefits Office should establish and follow the policies and procedures listed below:

- Establish contractual provisions requiring its vendors who process medical and prescription drug claims to have an effective internal control system to accurately and appropriately process claims. Additionally, obtain an independent annual audit of their claims payment processing controls to determine whether controls have been placed in operation and are operating effectively.
- Review the audit reports of its vendors' controls over claims payment processing, and require corrective action plans if deficiencies are noted.

- Require vendors to submit accurate and complete claims data, and establish verification procedures to ensure the appropriateness, completeness, and accuracy of the data. In addition, perform a comparison of vendor billing statements to supporting claims reports in a timely manner.
- Develop procedures and conduct audits of claims payment data to ensure that claims are paid for allowable services to eligible plan members only, in accordance with vendor fee schedules and the proper application of copayments.

A similar recommendation was previously provided in our Performance Audit of the Department of Administration Report No. 05-12, dated September 2005.

The Benefits Office should strengthen controls over administrative fee payments to vendors for the self-funded health insurance program

Contract vendors for the State's self-funded health insurance program are paid a monthly administrative fee based on the number of state employees and retirees enrolled in each of their plans. However, the Benefits Office did not have written policies and procedures to calculate the monthly enrollee count for each plan. In addition, the Benefits Office's calculations did not take into account changing enrollment each month for enrollees entering and leaving the plans during the month. As a result, vendors may not have been paid the proper amount for administrative fees. Further, at the beginning of the program, the Benefits Office instructed the Department of Administration, Management Services Division (MSD), to calculate the vendors' administrative fees without considering the changing enrollment during each month; however, later in the year MSD was instructed to adjust their previous enrollment calculations accordingly. However, the Benefits Office was unable to provide the auditors with the recalculated amounts, and it did not adjust previous payments to vendors accordingly.

To help ensure that the administrative fees are correctly calculated and the Benefits Office pays the proper amount of administrative fees, it should develop written policies and procedures for calculating enrollment that accounts for changing enrollment during each month. In addition, the Benefits Office should retain the monthly enrollment calculations to support the amount of administrative fees paid to the vendors. Further, the Benefits Office should recalculate prior enrollment counts for each month, reimburse vendors for any resulting underpayments, and collect any resulting overpayments made to vendors.

A disaster recovery and business continuity plan should be prepared for SPIRIT

The State uses an Internet application called the SPIRIT system to manage its procurement process, including requesting goods and services, publishing bid solicitations, receiving and analyzing vendors bids, and awarding contracts. Therefore, it is vital that Enterprise Procurement Services (EPS) have a contingency plan so that state agencies can still purchase goods and services in the event of a major computer hardware, software, or telecommunications failure. However, EPS did not have a disaster recovery and business continuity plan for SPIRIT.

To help ensure that the State can provide for the continuity of its procurement operations and to help prevent data loss in the event of a major system, equipment, or telecommunication failure, EPS should develop and implement a disaster recovery and business continuity plan. The plan should include the following:

- Roles and responsibilities of employees assigned to disaster recovery teams, and emergency telephone numbers to reach them.
- A written equipment-backup agreement to support hardware needs and software requirements, including a designated physical facility.
- A listing of highest-to-lowest priority applications, required recovery times, and expected system performance.
- A listing of specific hardware, software, peripherals, and supplies needed, and a source for obtaining these items.
- System- and user-operating procedures.
- A list of procedures for processing critical transactions, including forms and other necessary documents.

A similar recommendation was previously provided in our Management Letter to the Department of Administration, Enterprise Procurement Services, dated February 7, 2005.

Enterprise Procurement Services should implement the controls over SPIRIT database management and operating system software

Proper configuration of SPIRIT's database management and operating system software helps prevent intruders and unauthorized users from making changes to programs and databases, and prevents virus attacks. Although EPS, the Information Processing Center, and the Data Resource Management Group have taken steps to address security risks, some controls were inadequate to properly secure data and system access. For example, some system utilities were not enabled to help ensure that file access rights were controlled to prevent unauthorized access to critical areas within the system and software updates, and network anti-virus software were not installed, which could leave the system and data vulnerable to attacks. In addition, audit log files were not reviewed regularly to detect unauthorized access or changes to the database or operating system. As a result, unauthorized activity could occur and go undetected.

EPS should ensure that controls built into the database management and operating system software are implemented to adequately safeguard SPIRIT from unauthorized use and changes. The following controls will help to secure the system:

- Ensure that file access rights are controlled to prevent unauthorized access to critical areas within the system.
- Install and maintain updated network anti-virus software.
- Install upgraded database and operating systems software in a timely manner.
- Use logs and system activity reports to detect any unauthorized changes.

A similar recommendation was previously provided in our Management Letter to the Department of Administration, Enterprise Procurement Services, dated February 7, 2005.

JANET NAPOLITANO
Governor



WILLIAM BELL
Director

ARIZONA DEPARTMENT OF ADMINISTRATION

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June 21, 2006

Dennis L. Mattheisen, CPA
Financial Audit Director
Office of the Auditor General
2910 N. 44th Street
Suite 410
Phoenix, Arizona 85018

Dear Mr. Mattheisen

Thank you for your letter of June 19, 2006 describing your findings in conjunction with the State of Arizona single audit.

Your findings are of tremendous interest to me. My staff and I take very seriously your recommendations. The implementation of the attached responses to your findings will be a priority in the coming months.

Please contact me at any time if you have any concerns about this document or any other matter within our agency.

Sincerely,

William Bell

Attachment

**Arizona Department of Administration
Response to Single Audit Findings
June, 2006**

Recommendation 1: The Benefits Office should strengthen controls over claims payment processing for the State's self-funded health insurance program

ADOA Response

- ADOA believes contractual changes can address the question of adequate internal controls from the vendors. During recent meetings the vendors, the SAS 70 audits were discussed. The vendors were advised that amendment language will be added to the contracts to require SAS 70 audits reports are to be submitted to ADOA annually. The amendments will be issued after JLBC reviews the contribution strategy, which is expected in July, 2006. ADOA will also develop amendment language that will address corrective actions, should such action be needed as a result of the SAS 70 audits.
- Additional audit procedures to verify the accuracy of claims that ensure the appropriateness, completeness and accuracy of claims and eligibility data. To that end, on May 8, 2006, an employee was hired whose primary responsibility will be to manage data to and from the vendors. This employee is currently reviewing the file formats from the vendors and will be working with them to ensure data received is readable and complete.
- Currently, ADOA does not have fee schedules to audit medical extract data. When ADOA is able to obtain the vendor fee schedules, either through contractual or legislative means, an auditing process will be developed for routine medical extract audits.

Recommendation 2: The Benefits Office should strengthen controls over administrative fee payments to vendors for the self-funded health insurance program.

ADOA Response:

- ADOA is preparing written procedures for the payment of administrative fees; ADOA will review these procedures with the Auditor General Staff. Should the procedures be acceptable to the Auditor General staff, ADOA will complete the documentation of the processes by September 1, 2006.
- ADOA will review past payments and create a reconciliation plan that ensures all past payments were accurate.

Recommendation 3: A disaster recovery and business continuity plan should be prepared for SPIRIT

ADOA Response

EPS will develop a business continuity plan and disaster recovery plan for SPIRIT by December 31, 2006. This may include that EPS will continue to rely on regular reports generated through SPIRIT, with pertinent solicitation and contract information so that business can be conducted with a manual, paper based system as used prior to implementation of SPIRIT.

The Information Services Division of ADOA has made it a priority to implement for all of its customers a disaster recovery processes. A common solution for those customers will address the specific needs of SPIRIT.

Recommendation 4: Enterprise Procurement Services should implement controls over SPIRIT database management and operating system software.

ADOA Response

- EPS and ISD will upgrade the Domino and Solaris software to current release levels which should address many of the concerns identified by December 31, 2006.
- Audit logging will be enabled during the Solaris operating system software upgrade. The Domino logs will be reviewed manually twice a week, based on automated mechanisms that have been implemented which sends e-mail notifications based on a list of pre-determined events.
- ISD has also received pricing for anti-virus software and is verifying its compatibility with the application. If satisfactory, EPS will acquire the software and ISD will schedule the installation.