

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

**DEPARTMENT OF INSURANCE**

**Investigation of the Insurance  
Examiners' Revolving Fund**

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**OFFICE OF THE**  
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DEPUTY AUDITOR GENERAL

November 7, 1995

Members of the Arizona State Legislature

Chris Herstam, Director  
Department of Insurance

**Subject: Department of Insurance**  
**Investigation of the Insurance Examiners' Revolving Fund**

Pursuant to our statutory responsibility set forth in Arizona Revised Statutes §41-1279.03, we are currently conducting a statewide single audit of the State of Arizona for the year ended June 30, 1995, and our reports thereon will be issued at a future date. As part of that audit, we are in the process of evaluating the effectiveness of the State's internal control structure design and operation. However, due to alleged irregularities involving the State of Arizona, Department of Insurance, Insurance Examiners' Revolving Fund, we have performed a special investigation of certain allegations concerning that Fund's operations and are transmitting our findings and recommendations concerning it separately in this report.

**Background**

The Insurance Examiners' Revolving Fund was established by Arizona Revised Statutes §20-159 to facilitate the required examinations of Arizona insurance companies. Through the Fund, the Department contracts with approximately 85 independent contract examiners to complete 350 insurance company examinations each year at a cost of approximately \$8,000,000 per year. The Fund provides compensation and reimbursement of certain examination expenses to the independent contract examiners. The examination costs are then recovered from the insurance companies examined and deposited into the Fund. A 15 percent administrative charge is added to the costs recovered to pay for the Department's administrative costs. The Fund is administered by three Department employees and several contract examiners.

Through the competitive sealed proposals process, the State Procurement Office provides the Department with a list of authorized contract examiners by category of examination work. The contracts awarded by the State Procurement Office do not guarantee any examination work to the individual contractors; rather, they only qualify the contractors to perform examination work for the Department. The Department assigns examination work by category to the listed contractors, and, according to State Procurement Office officials, there are no requirements the Department must follow when assigning examination work to the individual contractors.

### **Independent Contractors Are Provided Significant Employee Benefits**

The Department procured the services of and accounted for contract examiners as independent contractors. Consequently, the Department did not pay applicable federal and state employment-related taxes, nor did it withhold and remit applicable amounts from their compensation. During calendar year 1994, 20 of the individual contract examiners were paid compensation in excess of \$70,000 and 5 were paid in excess of \$100,000. The contract examiners' compensation was reported on IRS form 1099. However, the Department provided the contractors with office space, clerical assistance, business equipment, office supplies, training, direct supervision, sick and holiday pay, and reimbursement for travel expenses. Most contract examiners were provided with regular full-time work, contracting with no entities other than the Department. Several of these contract examiners were placed in managerial positions with responsibilities including setting budgets, reviewing work, and approving overtime for other contract examiners. Additionally, the Department influenced certain contract examiners' decisions regarding the hiring of assistants. The Department assigned the contract examiners' assistants directly to examinations, and trained and supervised them as if they were the Department's employees and not the contract examiners' assistants. Because, collectively, these working conditions strongly indicate that the employer exercises considerable control over certain contract examiners, they may meet the common law definition of employees and the Department may be liable for applicable employment-related taxes and withholdings on compensation paid to them.

### **Department Officials Participated in Several Decisions in Which They Had a Substantial Interest**

- **Deputy Director** - The Deputy Director directly supervised two individuals responsible for assigning examinations to individual contractors. One contractor that was frequently assigned examinations was a relative of the Deputy Director. Officially, the Deputy Director recused herself from all decisions regarding the contract work of her relative. However, on one occasion, the Deputy Director requested the nonrenewal of the contracts of several contractors competing with her relative for examination work. Additionally, on several occasions the Deputy Director made inquiries of Accounting Department personnel regarding the status of payments to her relative. These actions were potentially in violation of Arizona conflict-of-interest statutes (A.R.S. §38-501 et seq.).

- **Deputy Chief Examiner** - The position of Deputy Chief Examiner was filled by a contract examiner. The Deputy Chief Examiner used this position to help a relative of his obtain a supervisory position as evidenced by the fact that the Chief Examiner acknowledged that the Deputy Chief Examiner strongly encouraged the promotion of his relative on several occasions. However, no documentation was available to justify the relative's promotion. After the relative's promotion, the Deputy Chief Examiner was this employee's immediate supervisor. His supervisory duties included approving overtime, assigning examination work, reviewing work performance, and, at times, conducting examinations with the employee. This involvement was potentially in violation of Arizona conflict-of-interest statutes (A.R.S. §38-501 et seq.) because those statutes are applicable to contract employees.

### **The Department Unnecessarily Pursued a Beneficial Contract Award for One of Its Contractors**

Subsequent to the initial contract examiner awards made by the State Procurement Office (SPO) in 1994, the Director and the Executive Assistant Director met with an SPO official to recommend an additional contract award for Insurance Consulting & Examinations, Inc. (ICE). The Department also recommended additional awards for five other contractors. The recommended award for ICE was in the Assistant Examiner: Technical and Support Services category, the category that provides contractors with the highest rates of compensation. Based on certain representations made by the Department, the SPO official partially accepted the Department's recommendations making the subsequent award to ICE while declining to make the subsequent awards to the five other contractors. The SPO official considered the subsequent award to ICE an exception to ordinary procurement procedures; however, the meeting and subsequent award were not documented in the SPO's files.

We determined that the subsequent award may not have been necessary since ICE was already providing comparable services to the Department at lower rates under an existing contract in effect at that time. Both the Director and the Executive Assistant Director stated they were unaware of the existing contract when they made the request. By securing the subsequent contract award for ICE and assigning work under it, the Department paid more than was necessary for those services.

After we brought this matter to the Department's and the SPO's attention, SPO conducted its own investigation, which resulted in the SPO canceling substantial portions of the subsequent contract award to ICE.

### **The Department Did Not Adequately Monitor the Billings of Contract Examiners**

Our investigation disclosed the deficiencies listed below in the Department's policies and procedures for monitoring the billings submitted by contract examiners. These deficiencies increase the Department's susceptibility to fraud, waste, and abuse.

- The Department does not verify the hours billed by contractors in supervisory positions.
- The Department uses contract examiners to process the billings of other contract examiners. Two of these contract examiners processed the billings of the contract examination companies by whom they were employed and one of these contract examiners processed the billings submitted by his supervisor.
- The Department does not adequately scrutinize billings for unallowable reimbursements. As a result, contractors were reimbursed for various personal expenses, lodging in excess of the allowable contract rates, and miscellaneous expenses without being required to submit receipts or other supporting documentation.

### **Personal Travel Reimbursement Was Allowed**

The Deputy Chief Examiner had authority to schedule his travel and examination assignments. He scheduled travel to Los Angeles in 1993 in order to perform field audit work in the days prior and subsequent to attending the Super Bowl. Specifically, he traveled to Los Angeles Friday, January 29, 1993, and returned to Phoenix Monday, February 1, 1993. His travel expenses were charged to the Department and included airfare, 3 nights' lodging, 4 days' car rental, 4 days' airport parking, and 2 days' labor, totaling \$1,408.70. Had the work been scheduled for two consecutive days, the Department could have saved approximately \$440 by avoiding certain lodging, car rental, and parking expenditure reimbursements.

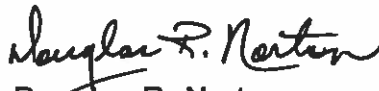
### **Recommendations**

1. The Department should exercise considerably less control over its independent contractors by maintaining a true independent arm's-length business relationship with them in both fact and appearance. Few, if any, of the factors the Internal Revenue Service considers indicative of an employer-employee relationship should be present in the Department's dealings with its independent contractors. This would help ensure that the Department is not exposed to the additional employment-related liabilities that such a ruling by the Internal Revenue Service would cause.
2. To help ensure compliance with Arizona conflict-of-interest statutes (A.R.S. §38-501 et seq.), the Department should not allow contract examiners or regular employees to make decisions or have control over or input into decisions in which the contract examiner or employee, or their relative, would have a substantial interest.
3. The Department should more effectively administer existing contracts by maintaining a thorough knowledge of all services that are available and the terms and conditions of obtaining those available services. This will help ensure that additional contracts are pursued only when necessary and advantageous to the Department.

4. The Department should develop more effective policies and procedures to monitor contract examiners' billings that include verification and approval of hours worked by examiners in supervisory positions, ensuring that contract examiners do not process their employers' billings, and that reimbursements are not made for unallowed expenses. This will help ensure that contract examiners are compensated only for those services actually provided and reimbursed only for allowable expenditures actually incurred.
5. To help ensure that the Department does not reimburse personal travel expenditures, the Department should develop policies and procedures governing reimbursement for weekend travel expenditures and prohibiting preferential travel assignments.

This letter is intended for the information of the members of the Arizona State Legislature and the Director of the Department of Insurance. However, this letter is a matter of public record and its distribution is not limited.

Should you have any questions concerning the contents of this letter, please let us know.

  
Douglas R. Norton  
Auditor General

**AGENCY RESPONSE**



STATE OF ARIZONA  
DEPARTMENT OF INSURANCE

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CHRIS HERSTAM  
Director of Insurance

November 2, 1995

Ms. Debbie Davenport  
Deputy Auditor General  
Auditor General's Office  
2910 North 44th Street, Suite 410  
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RE: Special Investigation of Insurance  
Examiners' Revolving Fund (IERF)

Dear Ms. Davenport:

Thank you for allowing the Arizona Department of Insurance (Department) the opportunity to respond to your report of the above-referenced special investigation. We appreciate your constructive approach. The information you have provided has facilitated our remedial measures, which we believe have already largely addressed your criticisms. The problems identified arose out of the system this administration inherited for utilization of procured contract examiner services. That system was implemented in 1991 for the valid purpose of reducing a backlog of mandatory financial examinations and achieving the Department's accreditation by the National Association of Insurance Commissioners (NAIC). The system succeeded in fulfilling that purpose.

Your report identifies one essential systemic defect in the Department's contract examiner program, along with related consequences and isolated irregularities. You find that the Department's treatment of its independent contractor examiners may constitute treatment as employees within the meaning of common law, and that certain contractors have been permitted to exercise managerial authority over others. We have already implemented significant remedial measures, and a plan for further measures when appropriate. We have created and filled a full-time employee (FTE) position to assume the duties of Deputy Chief Examiner. The individual who performed those duties as a contractor has been reassigned to field examination work, where he does not administer other contractors on the Department's behalf. Additionally, we have created and filled an FTE position to perform the duties of Chief Market Conduct Examiner to exercise managerial authority over the contract examiners performing market conduct examinations. We are presently in the process of creating seventeen (17) new FTE positions in our Corporate and Financial, Market Conduct and Business Services Divisions to provide necessary clerical and administrative support for

effective administration of contract examiner services by the previously described new managerial employees. Like the contractor services they replace, these seventeen (17) FTEs, and the Chief Market Conduct Examiner position, are funded by the IERF.

We firmly believe that appropriate use of contract services for financial and market conduct examination and analysis is expressly authorized and absolutely necessary to fulfill the Department's statutory duties. Further, a certain degree of training, control over the method of the work, and close interaction between contractors and Department employee staff is necessary and critical to the Department's effectiveness and continued accreditation by the NAIC. We do not believe that appropriate training, control and interaction under such circumstances runs afoul of the common law tests for distinguishing contractors from employees. However, we agree that some provisions of the Department's written Guidelines For Arizona Independent Contractor Examiners must be amended to enhance compliance with the common law tests. We will make those amendments, including discontinuance of holiday compensation and reimbursement of expenses relative to sick days and holidays, at the first fair opportunity to effect changes in the contractual terms.

We make the following response to your findings as to isolated irregularities:

1. Deputy Director - You note that the former Deputy Director requested the nonrenewal of contracts of her relative's competitors. She did not, in fact, participate in the nonrenewal decisions. She merely inadvertently signed a letter mistakenly made out for her signature and placed before her by another employee. This mistake occurred approximately three (3) weeks after her appointment as Deputy Director, when new procedures regarding procurement decisions had not become routine. The former Deputy Director resigned from state service in July 1995 after ten (10) years at the Department, where she greatly benefitted Arizona insurance consumers.

2. Meeting with State Procurement Office (SPO) - You describe a meeting between the Director and Executive Assistant Director and an SPO official regarding a contract award to Insurance Consulting & Examinations, Inc. (ICE). In fact, the Director and Executive Assistant Director did no more than meet with the SPO official to provide recommendations to the SPO, at the SPO's request, with respect to ordinary contract examiner awards. The meeting occurred after the formal date of the awards entirely because the SPO did not provide the Department a complete and accurate description of the proposed awards until after the SPO had made the awards. In our view, the SPO created an unfortunate situation in failing to provide full information prior to making the awards. You correctly note that at the time the Director and Executive Assistant Director were unaware of the

existing ICE contract, which had been procured by the SPO prior to the current administration of this Department. The matter has been resolved by the SPO's amendment to the affected ICE contract. We note that some of the Department's recommendations which the SPO declined to accept would have resulted in savings to the IERF.

3. Personal Travel Reimbursement - This incident predates the current administration of this Department. It is our understanding that the previous Director investigated the matter and resolved it as she deemed appropriate.

We make the following response to your recommendations:

1. We agree the Department's control over its independent contractor examiners should be reduced to the minimal level necessary to fulfill statutory duties and maintain NAIC accreditation. We will amend our guidelines toward this end at the earliest appropriate opportunity.

2. We agree contractors should not exercise policy level administrative authority on behalf of the Department. The creation of new FTE management positions in our Corporate and Financial and Market Conduct Divisions remedy this problem.

3. Current management has now procured or renewed all extant contracts for services, and has developed historical knowledge in this area resulting in more informed decisions.

4. We agree more effective control over contractor billing and payment is required. We have already begun to create seventeen (17) new FTE positions, to be funded by the IERF, to provide clerical and administrative support of our contract examiner program. This will enable us to develop and implement appropriate policies and procedures for employee control of contractor billing and payment.

5. We agree, and will review and revise as necessary our policies and procedures as to examiner travel.

Thank you again for your professionalism, courtesy and assistance.

Sincerely,



Chris Herstam  
Director of Insurance

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