BWC Board of Directors

# AUDIT COMMITTEE

**Thursday, March 24, 2011, 8:30 a.m.**
**William Green Building**
30 West Spring Street, 2nd Floor (Mezzanine)
Columbus, Ohio 43215

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Members Present: Kenneth Haffey, Chair
Robert Smith, Vice Chair
Stephen Lehecka
Dewey Stokes
Nicholas Zuk

Members Absent: None

Other Directors Present: James Hummel, Thomas Pitts, Larry Price, David Caldwell, Mark Palmer, James Matesich

Counsel Present: Tom Sico, Assistant General Counsel
Ann Shannon, Legal Counsel
Janyce Katz, Assistant Attorney General

Staff Present: Stephen Buehrer, Administrator
Caren Murdock, Chief of Internal Audit
Tracy Valentino, Chief of Fiscal and Planning
Thomas Prunte, Executive Director, Employer Management Services
Don Berno, Board Liaison

Scribe: Jill Whitworth

**CALL TO ORDER – MARCH 24, 2011**

Mr. Haffey called the meeting to order at 8:30 AM and the roll call was taken. All committee members were present.

**MINUTES OF FEBRUARY 23, 2011**

The minutes were approved without changes by unanimous roll call vote on a motion by Mr. Smith, seconded by Mr. Stokes.

**REVIEW/APPROVE AGENDA**

There were no changes to the agenda. Mr. Haffey noted an executive session would be held at the conclusion of business. The agenda was approved by unanimous roll call vote on a motion by Mr. Zuk, seconded by Mr. Smith.

**NEW BUSINESS / ACTION ITEMS**

1. **Second Reading**
   a. **Electronic Submission of Documents, Rule 4125-1-02**

Tom Sico, Assistant General Counsel, noted this rule is part of the five-year rule review, and is one of two joint rules with the Industrial Commission. This rule has no changes and will be re-filed in existing form. It remains subject to the review/hearing process of the Joint Committee on Agency Rule Review (JCARR). Through the rule review process, 70-80 rules have been consolidated or eliminated over the past few years.

The purpose of Rule 4125-1-02 is to provide further opportunity to engage in electronic commerce and communication with BWC customers. There were no further stakeholder comments or feedback with respect to the rule, and no discussion by the committee.

Mr. Smith moved that the Audit Committee recommend that the BWC Board of Directors approve the Administrator's recommendation on the five-year rule review of Rule 4125-1-02 of the Administrative Code, "Electronic Submission and Acceptance of Documents". The motion consents to the Administrator retaining without change Rule 4125-1-02 as presented here today, and to filing the Rule jointly with the Industrial Commission upon approval of the Industrial Commission. The motion was seconded by Mr. Stokes and approved by unanimous roll call vote.

2. **Discount Rate and Financial Metrics**

Tracy Valentino, Chief of Fiscal and Planning, presented a summary of materials addressing the reserve discount rate and financial performance metrics. Her presentation included reference to the "Reserve Discount Rate Recommendation" handout, the memorandum dated March 8, 2011 from Bruce Dunn, Chief Investment Officer to the Administrator entitled "CIO Discount Rate Setting Comments, State Insurance Fund, Fiscal Year 2012", and the "Ohio Bureau of Workers' Compensation Financial Performance Metrics" dated March 23, 2011, which are incorporated by reference into the minutes.

The discount rate recognizes the time value of money in order to meet future claim obligations. Long-term investment returns are reviewed along with two standards: the Government Accounting Standards Board (GASB) Statement #10, which permits management to make judgments within the framework of certain guidelines, and the Actuarial Standard of Practice # 20.

The executive team, including Ms. Valentino, Administrator Buehrer, Chief Investment Officer Bruce Dunn, Chief Actuarial Officer John Pedrick, and Chief Operating Officer Ray Mazzotta, met on March 15, 2011 to review and discuss the discount rate. Consistent with prior practice, a gradual reduction of the discount rate has been achieved over the past few years to approach a risk-free rate of return without significant impact on employers. While no investment is truly risk-free, BWC evaluates the discount rate by comparison with other state funds and private insurers, investment returns, changes in investment strategy and financial markets, and a review of AA corporate bonds and 20-year Treasury notes. The recommendation is to leave the discount rate at 4%.

Mr. Smith commended Ms. Valentino and others who worked on this project for a well-reasoned and supported recommendation. Per a question from Mr. Haffey, Mr. Lehecka said he was comfortable with the recommendation, but in the future he requested the process include the duration of reserves and sensitivity to interest rate changes.

The presentation then moved to financial performance metrics. Several ratios are reviewed to make sure targets remain appropriate and results are being met. While the ratios enable BWC to benchmark against its industry peers, Ms. Valentino cautioned this is not a true "apples to apples" comparison because a government entity has some flexibility unavailable in private industry. BWC developed these ratios after the initial Deloitte study.

The Funding Ratio and Net Leverage Ratio are applicable only to the state insurance fund. The loss and expense ratios measure profitability. The operating ratio incorporates investment income. At this point, comparative data is being compiled from industry analysts A.M. Best and Ward Group, as well as financial statements from other state funds, to be used in evaluating projections for the next fiscal year. Ms. Valentino also asked the directors to advise her if they believed any other metrics should be utilized.

**3. PEO Education Session**

Thomas Prunte, Executive Director of Employer Management Services, gave a presentation with respect to professional employer organizations (PEO's). His presentation included reference to the "Professional Employer Organizations" handout dated March 24, 2011, which is incorporated by reference into the minutes. Mr. Haffey noted Ms. Murdock had referred to this topic in a previous QES presentation to the Committee, and today's session was to assist the Committee in developing a greater understanding of how PEO's function.

In summary, a PEO contracts with one or more client-employers to co-employ all or part of the client workforce. The PEO becomes the employer of record. The client maintains its own BWC policy, but reports zero payroll, and benefits from the PEO's experience modifier. There is no limit on how often a PEO can change clients, which in turn changes the overall risk exposure. BWC currently regulates 238 PEO's with an aggregate $400 million payroll. Six of these PEO's are self-insured.

Per a question from Mr. Smith, Mr. Prunte explained that BWC is the oversight body for PEO's in Ohio, although there is a variety of interaction with other state agencies. PEO's vary in size and clientele. Partial leasing arrangements make up less than 1% of PEO business in Ohio. A small group of PEO's are involved in group rating and subject to those rules as well.

The concept of a PEO began with employee leasing operations in the 1970's. By 2007, PEO's were regulated in 33 states. BWC first recognized PEO's in 1997 with the creation of Rule 4123-17-15. However, several PEO bankruptcies spotlighted problems with the system, including client-employers being assessed for premiums they had already remitted to the PEO, and inability to transfer experience back to the client-employers. This led to the adoption of Ohio Revised Code 4125 in 2004, which was created by the

PEO industry and stakeholders. However, issues remain because client rosters shift throughout the year and are not required to be reported other than annually.

PEO agreements with clients must be of at least one year in duration, and are contemplated to be ongoing as opposed to temporary in nature. There are various penalties for non-compliance with the statute and rules. Recently there has been a substantial increase in additional clients for self-insured PEO's. This has created another issue, in that there is no experience to transfer if the client employer returns to the state insurance fund. Mr. Smith questioned how this could logically occur. Mr. Prunte stated that BWC lacks the data to perform such a function.

Last fall BWC engaged a consultant to review PEO regulations, which produced the following recommendations:

- Require PEO's to report by employer, not in the aggregate;
- Require the PEO's to provide data to client-employers;
- Require quarterly reporting of client rosters; and
- Enhance securitization requirements for SI PEO's to protect the Self-Insured Employer Guaranty Fund.

Except for the SI PEO recommendation, the others are included in legislation currently being proposed by PEO stakeholders.

Mr. Price asked what financial impact PEO issues have on BWC. Mr. Prunte responded that predictions cannot be made due to a lack of data. A plan is in place to audit all existing PEO's.

**4. Internal Audit Quarterly Executive Summary (QES) Update**

Caren Murdock, Chief of Internal Audit, reviewed the FY2011 2nd Quarter Executive Summary for Internal Audit. Her presentation included reference to the "FY 11 2nd Quarter Executive Summary Report" of March 24, 2011, which is incorporated by reference into the minutes.

The report covers the quarter ending December 31, 2010. The Internal Audit Division (IAD) performed three audits during this period.

IAD conducted an audit of Special Claims, which processes and services claims of a unique nature, such as claims involving BWC employees or their family members, employers or injured workers located outside of Ohio, and rehab claims. There were no material incidents of non-compliance with policy. A "Significant Weakness" was discussed in that there is no continuous monitoring process to verify claims and policies are identified, flagged, and properly reassigned to ensure employees do not have access to their claim or policy.

IAD conducted an audit of procurement of investment management services, to verify that two Requests for Proposal followed statutory and investment policy mandates. Nothing significant was found and Ms. Murdock characterized this as a "very clean audit".

An internal audit of Managed Care Organization (MCO, identified in the report as MCO Audit #1) determined that internal controls are not operating effectively. A "Material Weakness" was found in that there are no systematic adjustments to medical bills, resulting in overstated amounts and potential billing errors. Ms. Murdock also referenced two comments of "Significant Weakness". Comment 2 involves failure to effectively review vocational rehabilitation costs, resulting in repetitive services, excessive travel costs, and unwarranted denial of services. Comment 7 noted a failure to timely terminate employee access to information once the employment relationship ended.

Ms. Murdock next gave a general overview of 59 outstanding internal audit comments. This is the lowest number of outstanding comments since tracking began in FY 07. 86% of all outstanding comments are scheduled to be implemented within the next six months.

Ms. Murdock gave brief overviews of outstanding comments in the following areas:

- Medical Bill Payment Process (P. 9-10)
  Enhancements are being made to the system to insure that appropriate provider recertification is being done.

- Subrogation (P. 10)
  IT continues to work on system enhancement.

- Bankrupt Self-Insured Securitization (P. 11-12, comments 2 and 5)
  The collection process policy has been updated, monthly reporting is being developed and management is consulting with IT to create a systematic fix to track security balances.

- Employer WCIS Credit Transactions (P. 13)
  IT continues to develop V3 system enhancements.

- Fixed Asset Audit (P. 14, Comment 4)
  Management has accepted the risk associated with this comment through the use of contract employees and scanning technology to conduct physical inventory. Ms. Murdock reviewed the policy for risk acceptance on page 21 of the QES, and explained that such comments are moved from the QES to another document that is reviewed quarterly.

Ms. Murdock noted no additions or deletions this quarter to the annual audit plan, although some projects may experience a slight delay. Mr. Matesich asked if IAD is fully staffed. Ms. Murdock replied in the negative, but noted that all important projects are being conducted. Some low-to-medium risk projects have been set aside, but IAD and management are aware that these risks have been assumed.

## DISCUSSION ITEMS

### 1. Open Discussion with Internal Auditor

Ms. Murdock reported that 12 reviews are in process – 3 in planning, 6 in field work (5 of which will be completed this quarter) and 3 in final phase. IAD's validation for presentation in the June Quarterly Executive Summary has just begun, with management responses due 3/25/11. Ms. Murdock commended two of her staff members who recently passed the certified internal auditor examination. Of the 13 internal audit team members, 5 have Master's degrees, 7 are Certified Public Accountants and 5 are Certified Internal Auditors.

### 2. Committee Calendar

There were no changes to the calendar. The April meeting will feature discussion of the external audit and first reading of the administrative budget. Mr. Haffey and BWC staff will be meeting with the external auditors prior to the April meeting.

### 3. Executive Session

Mr. Haffey moved to recess for an Executive Session to consider a report from Joe Bell of the Office of Budget and Management, Internal Audit Division. Mr. Haffey announced the meeting will adjourn immediately following the return from Executive Session. The motion was seconded by Mr. Stokes and approved by unanimous roll call vote. The Committee entered Executive Session at 9:58 AM.

## ADJOURNMENT

At 10:18 AM, Mr. Stokes moved to return from Executive Session and adjourn the meeting. The motion was seconded by Mr. Zuk and approved by unanimous roll call vote.