Auditor's Home Page List of Audit Reports

Table of Contents

Executive Summary Click Here To View i

Introduction 1

Background 1

Objective, Scope, And Methodology 6

Finding I
Following A City Auditor-Recommended And City Council-Approved Policy Would Reduce The City's Outstanding Liability For Workers' Compensation Claims By $20.8 Million As Of June 30, 2005 7

City Auditor's January 1994 Audit Of The Workers' Compensation Program Claims Database 8

The City Council Approved Recommendation #1 In The City Auditor's Report 9

The City Auditor's Recommendation Is Consistent With Governmental Accounting Standards Board Statement No. 10 9

The Governmental Accounting Standards Board Approved The City Auditor's Interpretation Of GASB 10 12

The City's External Auditors Approved The City Auditor-Recommended Methodology To Calculate And Report The Workers' Compensation Claims Liability 13

1994 Recommendation Follow-up 13

During 2005, The City Auditor Learned That, Contrary To City Council Policy, The City Had Reverted To Using An Actuarial Study To Estimate Its Workers' Compensation Claims Liability 13

A September 2004 Workers' Compensation Claims Audit Supported The Reliability Of The Claims Reserves In The City's Workers' Compensation Database 14

Two Database Reserve Reports Validated The Reasonableness Of The Lower Estimated Liability 17

The City's External Auditors Agreed The Database Method Can Be Relied Upon To Calculate The Estimated Liability 18

CONCLUSION 19

RECOMMENDATIONS 19

Appendix A Click Here To View
Definition Of Priority 1, 2, And 3 Audit Recommendations A-1

Table of Exhibits

Exhibit 1
Employee Services Department And The Program Organization Chart 2

Exhibit 2
Estimated Liability Based On City Auditor's Recommended Method..... 14

Exhibit 3
ARM Tech Workers' Compensation Claims Audit Reserve Analysis 16

Introduction

In accordance with the City Auditor's 2005-06 Audit Workplan, we audited the City of San Jose's (City) Workers' Compensation Program. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Objective, Scope, and Methodology section of this report.

The City Auditor's Office thanks the Department of Finance, the Department of Employee Services, and Macias Gini & Company LLP who gave their time, information, insight, and cooperation for this audit.

Background

Workers' Compensation

Workers' Compensation is a State mandatory statutory program established to compensate workers for injuries or illnesses sustained in the course of their employment. The benefits are in accordance with the State of California workers' compensation laws and City Memoranda of Agreement. The Department of Employee Services (Employee Services) administers the City's Workers' Compensation Program (Program).

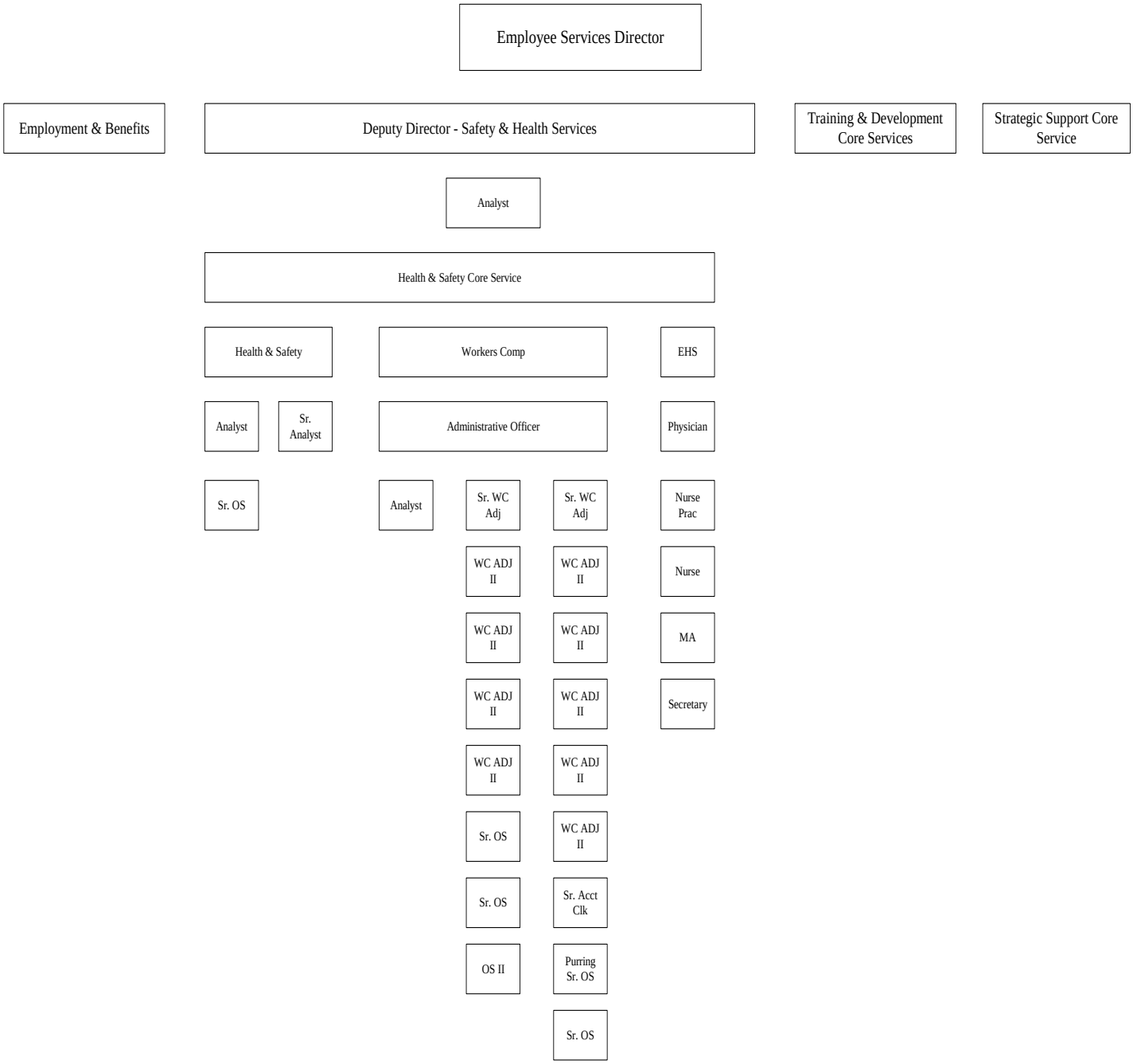
Department Mission

The mission of Employee Services in administering the Program is:

> *To provide City employees with Health, Safety, Wellness and Ergonomic resources, information and training through innovation, creativity and continuous improvement thus increasing employee morale and productivity while substantially reducing employee injury, suffering and illness.*

Exhibit 1 shows the organization chart for Employee Services and the Program.

Exhibit 1 Employee Services Department And The Program Organization Chart



Source: Employee Services Website on the City of San Jose Intranet.

The Five Major Benefits

The California Workers' Compensation Act provides for five major benefits.

1. *Medical Care* – The injured employee is eligible for all reasonable medical care necessary to cure or treat an injury.

2. *Temporary Disability* (TD) – The injured worker is also entitled to a TD benefit, which is the wage loss benefit payable during absence from work authorized by a medical practitioner.

3. *Permanent Disability* (PD) – The injured employee may also be entitled to a PD benefit, which is a benefit predicated on the reduction of the worker's ability to compete for a job in the open market.

4. *Vocational Rehabilitation* (Voc Rehab) – Should the worker be unable to return to his/her employment, he/she may be entitled to Voc Rehab benefits which include continued payment of any necessary medical expenses, vocational training under an approved plan, payment of maintenance allowances (Voc Rehab TD) while training, and additional living expenses necessitated by the plan.

5. *Death Benefit* – Should death ensue as a result of an injury that is found to be compensable under the compensation laws, the deceased's family may be entitled to death benefits and burial expenses.

Types Of Claims

There are four types of claims. They are information-only, medical-only, indemnity, and death.

Information-Only Claims

Information-only claims are filed to document an injury or an illness when an employee does not plan to seek medical attention. For example, information-only claims are filed when an employee suspects work-related exposure to communicable diseases, toxic substances, or smoke from fires. The purpose of filing a claim is to document the incident in case disease or injury develops at a later date that could be related. Neither the City as the employer, or the employee incur any costs and no reserve amount is required.

Medical-Only Claims

Medical-only claims are filed for work-related injuries or illnesses for which lost time does not exceed three days. The City, as the employer, pays all costs of medical treatment. The City assigns a beginning reserve amount of $2,000 to all medical-only claims.

Indemnity Claims

Indemnity claims are filed for a work-related injury or illness which normally results in loss of time from work. The employee is compensated for lost time and all medical costs of the injury or illness. The two major types of indemnity claims are Temporary Disability (TD) and Permanent Disability (PD). Current workers' compensation law provides for a maximum of $840 per week for TD and a maximum of $270 per week for PD.

- Temporary Disability. Employees with work-related illnesses or injuries receive a State-mandated TD amount of $840 maximum per week. In the City, negotiated Memoranda of Agreement provide additional compensation in the form of a disability leave of absence or disability leave supplement (DLS) when employees are on TD. Sworn personnel receive TD of $840 per week and DLS to equal 100 percent of their regular salary, while non-sworn receive TD and DLS to equal 85 percent of their salary. TD and DLS are paid out of departments' personal services budgets. Adjusters reserve for the ultimate estimated cost of these claims, including TD but not including DLS.
- Permanent Disability. Most kinds of compensation available in workers' compensation systems are attempts to compensate for loss of either earnings or earning capacity and are usually paid or accrued weekly. The basis for an award of compensation is the worker's earnings at the time of injury or death and the fact that it was work-related, not the nature or location of the injury or the manner of inception of the disease. Compensation for PD is based on the State of California's Schedule For Rating Permanent Disabilities. The schedule rates a disability based on such factors as the claimant's age, occupation, and extent of injury to evaluate his or her ability to compete in the open labor market.

Death Benefit Claims

Death benefits in workers' compensation claims include burial expenses and support for the dependent survivors of the deceased employee. In addition, any payments for either temporary or total disability due and unpaid at the time of death are paid to dependents. Adjusters establish a reserve amount for future payments of the death benefit.

Medical-only and indemnity claims are the most frequently reported types of claims. In 2004-05, 1,298 claims were reported: 541 were medical-only and 757 were indemnity claims. The total number of claims reported in 2004-05 is down 58 from the 1,356 claims reported in 2003-04.

Claims Management

In 1991, the Program acquired a claims data management system that aids the adjusters in managing their caseloads. The stand-alone, computerized David System, designed by the David Corporation, with Release 5.1 of CompPlus software, came on-line in July 1991. The system tracks the status of claims, produces management reports, and generates workers' compensation payments.

Employee Services is currently in the process of upgrading from a dot-matrix system to a Windows-based system, Renaissance, which will

- enhance claims management functions;
- streamline the claims payment process;
- facilitate Electronic Data Interchange in accordance with State-mandated reporting requirements; and
- allow on-line reporting of injuries.

Objective, Scope, And Methodology

The objective of our audit was to determine whether City Administration followed City Council policy in estimating the annual outstanding liability for workers' compensation claims for the Comprehensive Annual Financial Report (CAFR) for the year ending June 30, 2005. This is the first audit of the Workers' Compensation Program (Program). A second audit report will focus on Program claims administration. Our methodology included interviews with City personnel in Employee Services and the Finance Department. In addition, we:

- Reviewed the City Auditor's January 1994 audit report No. 94-01, *An Audit Of The City Of San Jose's Workers' Compensation Program Claims Database*;
- Reviewed Governmental Accounting Standards Board (GASB) Statement No. 10 *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*;
- Reviewed the estimate of outstanding claims liability Employee Services developed using the City Auditor's recommended methodology;
- Reviewed the September 8, 2004 ARM Tech workers' compensation claims audit;
- Reviewed two workers' compensation reports showing database claim reserve changes and totals; and
- Interviewed the City's external auditors from Macias Gini & Company LLP.

Finding I

Following A City Auditor-Recommended And City Council-Approved Policy Would Reduce The City's Outstanding Liability For Workers' Compensation Claims By $20.8 Million As Of June 30, 2005

In 1994, the City Auditor issued a report entitled *An Audit Of The City Of San Jose's Workers' Compensation Program Claims Database*. In that report, the City Auditor recommended and the City Council subsequently adopted a policy to "annually calculate the estimated liability for workers' compensation using current information in the workers' compensation claims database…" The City Auditor verified that the City had implemented the City Auditor's recommendation when calculating the estimated liability for workers' compensation claims as of June 30, 1994. During 2005, the City Auditor learned that, contrary to City Council policy, the City had reverted to using an actuarial study to estimate its workers' compensation claims liability. As a result, Administration staff requested that the City Auditor review the actuary's calculation and help Program staff calculate the financial statement implications of the City not following the City Council's policy. Accordingly, the City Auditor reviewed the Governmental Accounting Standards Board (GASB) Statement No. 10, a recent independent workers' compensation claims audit of the reliability of reserves in the workers' compensation database, two database reserve reports, and held several discussions with the City's independent external auditors. Based upon our review, the City Auditor, the Finance Department, Employee Services, and the City's external auditors concur that it is permissible and acceptable for the City to comply with the City Council policy to annually calculate the estimated liability for workers' compensation using current information in the workers' compensation claims database. By so doing, the City's outstanding liability for workers' compensation claims will be reduced by $20.8 million as of June 30, 2005.

City Auditor's January 1994 Audit Of The Workers' Compensation Program Claims Database

In January 1994, the City Auditor issued a report entitled, *An Audit Of The City Of San Jose's Workers' Compensation Program Claims Database*. The report stated that the City could reduce its financial statement liability for workers' compensation by $4.6 million over and above $4 million previously identified as of June 30, 1993 by relying on the claims database. Specifically, the audit of the City's Program database revealed the following:

- The City's preliminary estimate of Program liability as of June 30, 1993, was approximately $10.9 million more than the Workers' Compensation Fund's (Fund) cash reserves. As such, the City's fully-funded policy was not being followed. The Administration proposed a multi-year program to address this situation;
- The City's Program liability as of June 30, 1993, was based upon an actuarial study that was conducted in accordance with an internal City policy that was outdated and unauthoritative;
- Recent and future actuarial studies to determine the City's Program liability were and would be hampered by a lack of sufficient claims history information;
- Subsequent events reduced the City's Program liability as of June 30, 1993, by $4 million;
- Our survey of other California cities revealed that several rely on their own workers' compensation claims databases to estimate their workers' compensation liabilities;
- San Jose's average claims liability was in line with other California cities;
- The City had developed a computerized database for workers' compensation claims that was reliable and accurate enough to satisfy Governmental Accounting Standards Board requirements for estimating the workers' compensation liability. This new capability obviated the need for an actuarial study to estimate the City's Program liability;
- Relying on the information in the Program claims database to estimate the liability for workers' compensation claims reduced the City's financial statement liability by an additional $4.6 million as of June 30, 1993; and

- Administrative and auditing procedures were needed to maintain the integrity of the claims database.

The City Council Approved Recommendation #1 In The City Auditor's Report

The City Council approved Recommendation #1 in the City Auditor's 1994 workers' compensation claims database audit report. Specifically, Recommendation #1 directed the Finance Department to:

- *Annually calculate the estimated liability for workers' compensation using current information in the workers' compensation claims database. The estimate should include:*
- *Total reserves net of administrative costs on all claims in the database at year end;*
- *An allowance for incurred but not reported claims (IBNR) based on recent reporting patterns;*
- *An allowance for disability leave supplement (DLS) payments; and*
- *An allowance for discounting the liability based on expected investment yields and recent payment patterns. (Priority 1)*

On February 23, 1994, the Finance Committee unanimously accepted Recommendation #1. On March 8, 1994, the full City Council approved the audit report and accepted this recommendation.

The City Auditor's Recommendation Is Consistent With Governmental Accounting Standards Board Statement No. 10

The Governmental Accounting Standards Board (GASB) issued its Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues* in November 1989, establishing standards for risk financing and insurance-related activities of state and local government entities. During the course of several Finance Committee meetings, the City Auditor and City Administration discussed GASB Statement No. 10 paragraphs specific to (1) accepting risk, (2) recognizing and reporting risk, and (3) estimating claims liability. The interpretation of these three accounting and financial reporting concepts was a central point during the 1994 audit and resulted in the City Auditor's Recommendation #1 to place reliance on information in the claims database to calculate the estimated liability.

Risk Acceptance

Statement No.10 of the Governmental Accounting Standards Board (GASB 10) *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues* establishes accounting and financial reporting standards for risk-financing and insurance-related activities of state and local government entities, including public entity risk pools. State and local governments manage and finance risks in any number of ways ranging from purchasing commercial insurance for all risks of loss, to participating in public entity risk pools, to retaining all risks of loss. The City of San Jose neither participates in a pool nor purchases insurance. They are self-insured for workers' compensation claims and retain all loss risk. The City Auditor stated in the 1994 claims database audit:

> *It should be noted that GASB 10 requires the application of different principles if an entity is transferring or accepting risk. These principles do not apply to the City, which is self-insured and accounts for its Program liability in an internal service fund. The City has neither transferred its risk to another entity nor accepted risk from another entity. Thus, if losses exceed initial estimates, the City will assess itself an additional amount to reimburse the Fund for those losses either by increasing payroll rates or initiating a fund transfer. On the other hand, if losses are below initial estimates, the City may choose to reduce payroll rates or transfer money out of the Fund.*

Risk Recognition

GASB 10 requires state and local government entities to recognize and report risk in accordance with the following conditions:

> *State and local government entities other than public entity risk pools are required to report an estimated loss from a claim as an expenditure/expense and as a liability if both of these conditions are met:*
>
> *a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will also occur, confirming the fact of the loss.*

b. The amount of the loss can be reasonably estimated.

The City Auditor's 1994 claims database audit found that the City's Workers' Compensation Manager had directed adjusters to establish reserves in the system based on their estimate of the ultimate cost of an individual claim. The audit also found that workers' compensation staff made adjustments to reserve amounts as soon as losses became estimable.

Estimating Claims Liability

With regards to claims cost recognition, GASB 10 says:

> *A liability for unpaid claims costs, including estimates of costs relating to incurred but not reported (IBNR) claims, should be accrued when insured events occur*…[GASB Statement No. 10 defines IBNR:] *IBNR includes (a) known loss events that are expected to later be presented as claims, (b) unknown loss events that are expected to become claims, and (c) expected future development on claims already reported. IBNR, therefore, is largely an estimate of loss and claim adjustment expenses associated with future likely claims activity based on historical actual results that establish a reliable pattern.*

Furthermore:

> *Claims liabilities, including IBNR, should be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. Expenditures/expenses and liabilities may be estimated through a case-by-case review of all claims, the application of historical experience to the outstanding claims, or a combination of these methods.* [Emphasis added.]

The City Auditor's 1994 audit included a claim-by-claim review of all claims in the database. We found that (1) the City was aware of IBNR claims and (2) began paying on those claims earlier than the actuarial assumptions and trending predicted.

In March 1994, the City Auditor requested GASB to review and comment on the interpretation of GASB 10 in the 1994 audit report.

The Governmental Accounting Standards Board Approved The City Auditor's Interpretation Of GASB 10

The City Auditor contacted the Governmental Accounting Standards Board to discuss the interpretation of GASB 10. In a March 7, 1994 letter to GASB, the City Auditor wrote:

> *…the city is self-insured for workers' compensation and administers all its own claims. The city's workers' compensation division uses a sophisticated database with terminals on every adjuster's desk to monitor its claims. Adjusters are instructed to reserve claims for their estimated ultimate cost. They review claims reserves whenever any significant event occurs and/or at least once every six months. The eight adjusters and manager have a total of 128 years of experience managing claims and estimating claims costs. In our opinion, their estimates of total claims costs should satisfy the GASB 10, paragraph 53, requirement to report an estimated loss when it is both probable that an asset has been impaired and the loss is reasonably estimable. Further, this approach appears to be acceptable, if not required, by GASB 10, paragraph 54, which states*
>
> *When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range should be accrued. Even though the minimum amount in the range is not necessarily the amount of the loss that ultimately will be determined, it is not likely that the ultimate loss will be less than the minimum amount.*

In a March 30, 1994 letter, the GASB Director of Research responded to the City Auditor:

> *…regarding the methods of measuring claims liabilities for the city's workers' compensation internal service fund…The techniques you described appear to be sufficient for determining the estimable and probable liability for unpaid claims, including IBNR, in accordance with GASB Statement 10, paragraphs 53-57…*

The City's External Auditors Approved The City Auditor-Recommended Methodology To Calculate And Report The Workers' Compensation Claims Liability

During the course of the 1994 audit, the City Auditor's Office contacted the City's external auditors, informing them we would recommend booking the liability using the database methodology. The City's external auditors reviewed and were satisfied with our sampling methodology and reliability of the information in the claims database and expressed that the City Auditor's conclusions appeared to be well founded and adequately documented. As a result, the 1994 audit report stated:

> *It should be noted that the City's external auditors have informed the City Auditor's Office that reliance on the claims database to estimate the City's liability is allowable under GASB 10. Further, the use of the claims database would not result in their issuing an adverse or qualified opinion on the City's financial statements provided that the criteria in GASB 10 are followed.*

1994 Recommendation Follow-up

In October 1994, Recommendation #1 from the 1994 audit report was implemented. Specifically, the Finance Department responded:

> *We have calculated the estimated liability for workers' compensation using the method as recommended by the auditor. They will be completed on an annual basis.*

The City Auditor's Office verified that the Administration had implemented Recommendation #1 as of June 30, 1994.

During 2005, The City Auditor Learned That, Contrary To City Council Policy, The City Had Reverted To Using An Actuarial Study To Estimate Its Workers' Compensation Claims Liability

During our audit, we found that 1994 was the only year that staff estimated the liability using the auditor-recommended method. Subsequent to 1994, the Finance Department and then Employee Services have relied on actuarial studies rather than the database methodology to estimate the City's workers' compensation claims liability. As a result, Administration staff requested that the City Auditor review the actuary's calculation and help workers' compensation staff calculate the financial statement implications of the City not following City Council policy. Exhibit 2 compares the liability amount based on the City Auditor's recommended method to the amount the actuary recommended.

Exhibit 2 **Estimated Liability Based On City Auditor's Recommended Method**

Estimated Liability Based on City Auditor's Recommended Method

Database Reserve	$113,690,365	
IBNR Allowance	1,478,103	
DLS Allowance	9,346,112	
Discount Allowance	(18,590,462)	
Total	**$ 105,924,118**	**Discounted**
Actuarial Estimate of Outstanding Losses*	**$ 126,772,809**	
Net (Actuary – Auditor)	**$20,848,691**	

*Source: Actuarial Study, April 11, 2005, page 3

As the exhibit shows, the difference between the actuarially-calculated liability and the City Auditor-recommended and City Council-approved method to estimate the liability is over $20.8 million.

We reviewed additional information regarding the workers' compensation database in order to provide further assurance that the database method estimate was reliable and also to validate the reasonableness of the lower estimated liability. Specifically, we reviewed an independent workers' compensation claims audit and two database reserve reports the City Auditor requested workers' compensation staff to produce.

A September 2004 Workers' Compensation Claims Audit Supported The Reliability Of The Claims Reserves In The City's Workers' Compensation Database

In September 2004, ARM Tech, a risk management, actuarial and insurance consulting firm, performed a workers' compensation claims audit of the database. The reserving component was one of the aspects of claims management ARM Tech evaluated. According to the report, best practices require reserve practices to contemplate the following:

- Compensability of the injury.
- Nature and extent of injuries sustained by claimant:
  - estimated temporary disability
  - estimated permanent disability

- estimated rehabilitation expense
- estimated medical expense
- estimated apportionment.

- Potential recoveries and/or defenses made available to the City.
- Settlement trends of the venue.
- Potential litigation costs.
- Potential other expenses to investigate the claim.

Reserve Analysis

The firm found that the City's workers' compensation claims staff is taking these and other factors into consideration when establishing reserves. ARM Tech reviewed 162 workers' compensation claims and found exceptions in 19 (12%) of the claims reviewed for which they recommended reserve monitoring and adjustments. Specifically, ARM Tech recommended reducing reserves on 12 of 19 claims, increasing the reserve on one claim, and maintaining the reserve amount on six claims. Exhibit 3 shows the reserve analysis results.

Exhibit 3 ARM Tech Workers' Compensation Claims Audit Reserve Analysis

	Claim Number	Outstanding Reserve	Recommended Reserve
1	01000675	$140,572.69	$0.00
2	08054035	$480,735.17	$273,000.00
3	01000154	$99,969.90	$21,000.00
4	98000193	$220,830.62	$112,830.62
5	02001299	$59,918.04	$95,318.04
6	97000150	$35,720.76	$5,000.00
7	02000353	$40,899.94	$0.00
8	02000301	$48,820.51	$6,000.00
9	03000319	$47,185.36	$47,185.36
10	98001699	$286.40	$0.00
11	02000856	$59,709.24	$59,709.24
12	03000284	$1,926.39	$1,926.39
13	02000671	$29,763.10	$27,263.10
14	03000427	$1,948.59	$0.00
15	01001139	$23,322.73	$0.00
16	00001958	$86,158.92	$86,158.92
17	98000750	$34,815.04	$34,815.04
18	02000142	$35,379.92	$35,379.92
19	00001777	$23,524.00	$0.00
Totals:		**$1,471,487.32**	**$805,586.63**
Total Recommended Reserve Change + or (-)			**($665,900.69)**

Source: ARM Tech Workers' Compensation Claims Audit.

As Exhibit 3 demonstrates, ARM Tech's analysis showed that the City had over-reserved these 19 claims by nearly $665,901 and recommended reducing total reserves of $1,471,487 million to about $806,000, a 45 percent decrease in the City's outstanding liability for these claims. In addition, ARM Tech assessed the City's performance in reserving practices as

displaying commendable effort. Finally, when benchmarked against other jurisdictions, San Jose was placed in the 95th percentile for reserving practices.

Two Database Reserve Reports Validated The Reasonableness Of The Lower Estimated Liability

In the aggregate, total reserves for all open claims in the database should reflect workers' compensation staff's best estimate of the ultimate cost of each claim until it is resolved and closed. In other words, total reserves on workers' compensation claims equal what the City is liable to pay on each claim for as long as it is open – the estimated total liability. Workers' compensation staff adjust reserve levels (up or down) when they receive additional information on a claim or during periodic reviews of their claim inventory. Accordingly, in order to comment on the reliability of information in the claims database used to estimate the liability, the City Auditor requested workers' compensation staff to produce two database reserve reports. The first report showed reserve changes, or "loss development", during 2004-05 for all claims in the database with an injury date prior to July 1, 2004. The second report showed salvage value for claims closed in 2004-05 with an injury date prior to July 1, 2004.

Loss Development Report

Loss development is the net incurred change in reserves on all workers' compensation claims in the database. The loss development report workers' compensation provided showed that, during 2004-05, workers' compensation claims adjusters changed reserve amounts on about 1,830 of approximately 4,000 open claims in the database. The report also showed that net reserve level changes adjusters made during 2004-05 added about $19.7 million to the estimated liability. This amount of loss development added to the database indicates that the City's workers' compensation claims adjusters actively managed their claims throughout the year, increasing or reducing reserve levels appropriately as additional information on the claims was received to reflect their best estimate of the ultimate cost of the claims.

Salvage Value Report

Salvage value is the difference between the amount reserved to pay a claim and the amount that is actually paid until the claim is closed. Salvage is included in loss development and is always a negative number as it represents a reduction in the amount reserved to pay the ultimate cost of all claims. The report workers' compensation provided showed salvage value

for 2004-05 of -$8,458,038. This shows that, in the aggregate, claims in the workers' compensation database that closed in 2004-05 were over-reserved by nearly $8.5 million.

The loss development report and the salvage value report noted above provide assurance that claims adjusters are reserving for the ultimate cost of the claims and, therefore, the database methodology can be relied upon to calculate the City's estimated liability. This is consistent with the findings in both the 2004 ARM Tech workers' compensation claims audit and the City Auditor's 1994 claims database audit.

The City's External Auditors Agreed The Database Method Can Be Relied Upon To Calculate The Estimated Liability

The City's external auditors have informed the City Auditor's Office that reliance on the claims database to estimate the City's liability is allowable under GASB 10. Further, the use of the claims database would not result in their issuing an adverse or qualified opinion on the City's financial statements. Relying on the claims database for estimating the liability means that written policies and procedures for maintaining database reserves will be extremely important to ensure the accuracy and objectivity of reserving practices. In addition, conducting an annual audit of the workers' compensation database claims reserves was recommended. In its management letter, the external auditors stated:

> *We recommend the City's Finance Department work with the City Auditor to develop administrative and auditing procedures necessary to maintain the integrity of the claims database. As part of this process the City should address both: (1) the need for an independent claims auditing process and (2) establish a procedure to periodically (not less than annually) document and review historical adverse loss development trends.*

We recommend that Employee Services:

Recommendation #1

Follow the City Auditor-recommended and City Council-approved policy to estimate the annual outstanding workers' compensation claims liability. (Priority 2)

We recommend that the City Council:

Recommendation #2

Direct the City Auditor to conduct an annual claims administration audit to ensure accuracy and objectivity as part of a quality assurance program regarding the integrity of the workers' compensation database. (Priority 2)

CONCLUSION

During 2005, the City Auditor learned that, contrary to City Council policy, the City had reverted to using an actuarial study to estimate its workers' compensation claims liability. We reviewed the Governmental Accounting Standards Board (GASB) Statement No. 10, a recent independent workers' compensation claims audit of the reliability of reserves in the workers' compensation database, two database reserve reports, and held several discussions with the City's independent external auditors.

Based upon our review, the City Auditor, the Finance and Employee Services Departments, and the City's external auditors concur that it is permissible and acceptable for the City to comply with the City Council policy to annually calculate the estimated liability for workers' compensation using current information in the workers' compensation claims database. By so doing, the City's outstanding liability for workers' compensation claims will be reduced by $20.8 million as of June 30, 2005.

RECOMMENDATIONS

We recommend that Employee Services:

Recommendation #1

Follow the City Auditor-recommended and City Council-approved policy to estimate the annual outstanding workers' compensation claims liability. (Priority 2)

We recommend that the City Council:

Recommendation #2 **Direct the City Auditor to conduct an annual claims administration audit to ensure accuracy and objectivity as part of a quality assurance program regarding the integrity of the workers' compensation database. (Priority 2)**

Click On The Appropriate Box To View Item

Appendix A