California State Auditor

BUREAU OF STATE AUDITS

Department of Insurance Conservation and Liquidation Office:

Stronger Oversight Is Needed to Properly Safeguard Insurance Companies' Assets

July 2001
2001-102

The first five copies of each California State Auditor report are free. Additional copies are $3 each, payable by check or money order. You can obtain reports by contacting the Bureau of State Audits at the following address:

California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
(916) 445-0255 or TDD (916) 445-0255 x 216

OR

This report may also be available on the World Wide Web
http://www.bsa.ca.gov/bsa/

Alternate format reports available upon request.

Permission is granted to reproduce reports.

CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

July 31, 2001

2001-102

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the operations of the Department of Insurance's (department) Conservation and Liquidation Office (CLO). Specifically, we reviewed the operations of the CLO that are outside the control structure of the State and the effectiveness of the department's oversight process in monitoring the operations of the CLO.

This report concludes that the CLO does not adequately safeguard and conserve insurance companies' assets by following prudent business practices and adhering to established controls. Further, the department has not adequately overseen the operations of the CLO. During our review, we identified significant weaknesses in the CLO's inventory and asset identification process. As a result, the CLO failed to promptly safeguard insurers' assets. Further, we noted that the CLO does not effectively manage its contracts, its hiring practices need improvement, and it has spent at least $6 million on an automated claim processing system that does not meet its overall needs. In addition, the CLO uses a basis to allocate certain of its costs to insurers that is not equitable. We also found that the CLO has not recently updated its estate closing plans or prepared cash flow projections as a means for ensuring that investment decisions are optimized.

Moreover, the department and the CLO have not addressed many of the issues raised in our previous two audit reports, nor has the department ensured that the CLO takes corrective action on the findings reported by other external auditors and the CLO's internal auditor. Finally, the CLO has yet to establish comprehensive conflict-of-interest policies and guidelines for its employees and vendor contractors.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

CONTENTS

Summary 1

Introduction 7

Chapter 1

The CLO Neither Adequately Protects Insurers' Physical Assets nor Ensures That Investment Decisions Are Optimized 15

Recommendations 23

Chapter 2

The CLO Has Poor Practices in Place to Conserve Assets of Estates It Manages 25

Recommendations 41

Chapter 3

The Department of Insurance Must Strengthen Its Oversight of the CLO 45

Recommendations 52

Response to the Audit

Department of Insurance 53

SUMMARY

Audit Highlights . . .

Our review of the operations and internal controls of the Department of Insurance's (department) Conservation and Liquidation Office (CLO) disclosed that the CLO:

- ☑ ***Does not adequately safeguard and conserve assets that come under its control.***
- ☑ ***Has not updated estate closing plans since 1998, and has never included projected cash flow needs in these plans.***
- ☑ ***Does not effectively manage its contracts and its basis for allocating certain costs to insurers' estates is inequitable.***
- ☑ ***Has never adopted a comprehensive conflict-of-interest policy for its employees and contractors to follow.***
- ☑ ***Spent at least $6 million of insurers' money on a claims processing system that does not meet its needs.***

Additionally, the department has allowed the CLO to continue its poor management practices by failing to properly oversee its activities.

RESULTS IN BRIEF

The Department of Insurance (department) needs to strengthen its oversight of the activities of its Conservation and Liquidation Office (CLO). Through the CLO, the department is responsible for conserving and liquidating certain companies (insurers) doing business in the State that have financial or other problems or that are not authorized to transact business in California. Despite numerous findings in previously issued reports, a lack of adequate oversight and poor management practices still exist at the CLO.

In May 1994 and April 1996 the Bureau of State Audits issued reports stating that the CLO (called the Conservation and Liquidation Division in 1994) needed to improve its administration and management of conserved and liquidated insurers. For example, in our past audits, we found that the CLO did not regularly update its closing plans for the insurers' estates it managed, did not follow its policies and procedures for hiring, and failed to properly monitor contracts. Moreover, another independent auditing firm (external auditor) identified problems with the CLO's efforts to recognize and bill for reinsurance—a method used by insurers to spread a portion of their risk to other insurers, known as reinsurers. In exchange for taking on a proportionate share of the original insurer's risk, the reinsurer typically receives a percentage of the premiums paid by the policyholders of the original insurer. Once an insurer is conserved or liquidated, the CLO attempts to offset the claims paid on behalf of the insurer by collecting any applicable reinsurance. During our current audit, we found that the department and the CLO have not addressed many of the issues raised in our previous two audit reports, nor have they corrected some of the problems identified by the other external auditor. Among the problems we most recently identified are a failure to follow either department or CLO guidelines and procedures with respect to internal audits, hiring, and contracting; no recent reviews or updates of estate closing plans; and an allocation system that inequitably assigns fixed costs among insurers' estates.

The CLO does not adequately protect insurers' assets. For example, we found that the CLO did not complete an inventory of the assets of a title company it had seized until at least three weeks after receiving the seizure order. By allowing this much time to elapse, the CLO failed to adequately safeguard the fixed assets of the company. Seizures are ordered only when there is high risk that assets are being diverted or when the insurer is not licensed to conduct business in California and poses a threat to policyholders. Moreover, when the CLO attempted to sell the assets of this insurer at auction, it did not adequately protect all the assets offered for auction.

The CLO also does not ensure that investment decisions are optimized. For instance, the CLO has never included projections of cash flows in its estate closing plans or updated its plans since 1998, even though such plans would help the CLO maximize the assets of liquidated insurers and provide planning and budgeting information for the CLO's operations. In addition, the CLO has not evaluated its investment managers' fees since reducing them in 1998. Nor has it evaluated its investment guidelines and strategy since 1999, when the CLO added the ability to invest in the bonds of certain foreign countries beginning in May 1999. However, further revisions may be needed, as the investment pool it manages is now more than triple the size it was in 1996. Over the past three years, the average return on the CLO's investment pool was 5.94 percent, slightly higher than the 5.69 percent return on the State's Pooled Money Investment Account (PMIA), which has investments similar to the CLO's investment pool. However, for 2000, the CLO paid its investment managers an average of $930,000 without knowing whether another investment firm could achieve the same or better results for less.

In addition, the CLO has poor practices in place to conserve insurers' assets. For instance, the CLO does not seek competitive bids on contracts when it should. Moreover, the CLO does not effectively manage its contracts nor adhere to its own contractual agreements, causing it to overpay one contractor by more than $43,000. It also does not have effective policies and procedures for its contract managers to follow. Without such guidance, the CLO's contract managers are unaware of even the most basic management controls in this important area. Instead, they rely on accounting personnel who are neither responsible for nor have sufficient information about contracts.

Weak hiring practices is another problem we previously reported, but we found no evidence that the CLO acted on our recommendation. Our current audit found that the CLO does not ensure that its employees meet its minimum job qualifications by checking references to verify applicants' level of education and employment history—a weakness similar to the one we reported in 1996. Additionally, the CLO has never adopted a comprehensive conflict-of-interest policy for its employees and vendor contractors to follow, although in 1999 it discussed the need for such a policy and developed a draft that it has yet to finalize and implement. Shortcomings in these two areas could lead to erroneous or improper actions by CLO employees and, ultimately, the waste or misuse of estate assets.

In addition to not following prudent business practices, the CLO does not equitably allocate costs to insurers. Because the CLO has not recently verified the relevancy of its basis for allocating fixed costs to insurers, it has unfairly burdened some insurers while undercharging others. Fixed costs can include the CLO's rent, storage costs, and equipment depreciation. For example, in one month, the CLO inequitably charged one insurer almost $55,000 when it should have only charged $900 and failed to charge another insurer more than $4,000 in fixed costs. Further, because the CLO does not regularly review insurers' status to determine which ones meet its criteria for sharing a portion of fixed costs, one insurer has never been charged its fair share. Using the CLO's current basis for allocating fixed costs, we found that the insurer's estate should have paid more than $58,000 in fixed costs incurred since January 2000. Moreover, if the CLO were to use a method that we believe is more equitable, the amount of fixed costs that it should have allocated to this estate since January 2000 would increase to more than $190,000.

The CLO has also spent at least $6 million of insurers' money on a claim processing system that does not meet its needs. In 1995 the CLO initially spent $400,000 for a system that required modifications; however, before the CLO purchased the system, it did not adequately assess its claims processing needs. Despite a series of expensive modifications and ongoing maintenance costs that have increased the initial cost by more than $5.6 million, the system is difficult to use and is incapable of handling the CLO's claims processing needs. Consequently, the CLO's use of the system is limited, and it manually processes claims for reinsurance—a method that is inefficient, prone to error, and does not ensure that all reinsurance recoverables are identified and collected. In one instance, an employee of the

CLO's reinsurance department retired before he billed a reinsurance company for more than $900,000 and the CLO discovered the error only when the reinsurance company notified it months later.

Finally, the department has allowed the CLO to continue its poor management practices by failing to properly oversee its activities. Specifically, the CLO's internal auditor might have identified several serious weaknesses that we detected if the department had enforced state law and its policy that all administrative and accounting controls be reviewed to identify and audit the most risk-prone operations of the CLO every two years (defined here as an audit cycle). The internal auditor has not completed a full audit cycle, despite his five-year tenure with the CLO, and has yet to audit the inventory process and other critical areas within the CLO. The department has also not required the CLO to act on the recommendations made by either the CLO's internal auditor or external auditors. For example, since 1999 the department has been aware that the CLO did not have a comprehensive policy regarding employee conflicts of interest and incompatible activities. The CLO's internal auditor also reported this problem in calendar year 2000. Although the internal auditor and the chief operations officer developed a draft of such a policy as early as 1999, the CLO never finalized and approved it.

RECOMMENDATIONS

To adequately safeguard the fixed assets of insurers under its control, the department should ensure that the CLO promptly identifies and inventories insurers' assets and develops work plans tailored for each inventory, based on prudent business practices.

The department should also ensure that the CLO maximizes the return on the assets it manages by periodically reevaluating its investment guidelines to reflect changing conditions and requirements. In addition, the department should ensure that the CLO update its estate closing plans and include estimates of the future cash needs of each estate. The CLO should give this information to its investment managers to help them optimize their investments of estates' assets, and use the information for its own budgeting purposes. The department should also ensure that the CLO periodically evaluates its contract for investment

management services to ensure that the fees that it pays are reasonable compared to what other investment firms would charge to manage an investment pool of similar value.

To guard against squandering insurers' assets, the department should require the CLO to obtain competitive bids where appropriate, seek a $43,000 refund from the contractor it overpaid, and assign a unique number to each contract. In addition, the CLO should direct its contract managers to develop spreadsheets to track contract payments, periodically review the spreadsheets and the contracts to determine if and when they should be renewed, and ensure that contractors adhere to all contract terms and conditions.

The department should also require the CLO to verify that applicants being considered for a position meet its minimum job qualifications for education and experience, thus ensuring that it is hiring qualified applicants and promoting qualified employees to positions requiring technical knowledge and experience. The department should also see that the CLO finalizes, approves, and implements a conflict-of-interest policy.

In addition, the department should work with the CLO to review its options for fairly allocating fixed costs to insurers and make sure it develops a system of review to enable it to include only appropriate insurers in its fixed cost allocation and exclude from the allocation process insurers that should not be paying fixed costs.

The department should ensure that the CLO works diligently toward defining its overall system needs. In the event that the CLO chooses to purchase a new claims processing system, it should explore the option of alternative procurement, whereby the software company would have a direct financial stake in the successful implementation of the claims processing system.

To strengthen and improve its oversight process, the department should ensure that the CLO's internal auditor reviews all CLO accounting and administrative controls to identify and audit risk-prone operations at least once every two years. In addition, the department should ensure that the recommendations of its internal auditor are implemented or should document why they are not.

AGENCY COMMENTS

The insurance commissioner concurs with all our findings and believes the report validates concerns he had about the management of the CLO. In addition, the commissioner states that the report provides him the needed baseline to focus his efforts on improving the management of the CLO and ensuring that the assets of entities conserved are safeguarded and efficiently used. n

INTRODUCTION

BACKGROUND

The Department of Insurance (department) is responsible for protecting California policyholders by regulating the 1,600 insurance companies and 300,000 brokers and agents operating in the State (collectively referred to as insurers in this report). Taking a lead role in helping the department fulfill this responsibility, the Conservation and Liquidation Office (CLO) assists in conserving, rehabilitating, or liquidating financially distressed or insolvent insurers. Section 1011 of the Insurance Code (code) authorizes the insurance commissioner (commissioner), on obtaining a court order, to take possession of the real or personal property, books, records, and assets of an insurer and to conduct, as conservator, as much of the insurer's business as the commissioner deems necessary. In addition, Section 1013 of the code authorizes the commissioner to take possession of an insurer's assets without first obtaining a court order if certain conditions exist, such as the threat of embezzlement or wrongful diversion of company assets. The current commissioner was sworn in by the Legislature on September 18, 2000, following the former commissioner's resignation on July 31, 2000.

As of May 31, 2001, the CLO was managing the estates of 54 conserved or liquidated insurers. Forty-six of these insurers were incorporated in California and are referred to as domiciliary insurers. The remaining 8 insurers were incorporated in another state or country and are called ancillary insurers. According to Section 1064.3 of the code, when an ancillary insurer with operations in California is conserved, the court will appoint the commissioner as the ancillary receiver. As the ancillary receiver, the commissioner has the sole right to recover and liquidate certain of the ancillary insurer's assets located in California, pay certain priority claims established and allowed by the court, and pay necessary expenses of the proceedings. The code requires that the remaining assets of an ancillary insurer be transferred promptly to the receiver located in the insurer's state or country of incorporation.

During conservation, a financially troubled insurer is placed under court-ordered control of the insurance commissioner. If it is determined that an insurance company cannot be rehabilitated—that is, its identified problems corrected—the commissioner can apply for a court order to liquidate the company. During liquidation, the CLO closes the insurer, cancels its policies, and converts its assets into cash. After liquidation, the commissioner applies for a court order to distribute the liquidated insurer's assets to the policyholders, creditors, and other parties having a financial interest in the estate and distributes the assets in the order required by the code.

State insurance guarantee funds cover many policyholders of California-licensed insurers that become insolvent and are subject to conservation and liquidation. Two associations, the California Insurance Guarantee Association and the California Life and Health Insurance Guarantee Association, process and pay covered insurance claims to policyholders of all insolvent property, casualty, life, and health insurers, up to the limits specified by law. The CLO's responsibilities in managing conserved and liquidated insurers consist primarily of reviewing claims not covered by the insurance guarantee funds; determining the amounts owed to the claimants; and taking action to identify, marshal, and manage the assets of insurers in conservation to maximize the return to policyholders and general creditors should liquidation of assets become necessary.

The CLO administers an investment pool in which it deposits the cash assets of liquidated insurers under its management. As of May 2001 the market value of the investment pool was more than $916 million. Section 1035 of the code allows the CLO to allocate all the costs of managing the estates under its control among those qualified conserved and liquidated insurers with sufficient assets to pay these costs. Annual appropriations from the department's Insurance Fund pay for the management of estates without sufficient assets to cover the administrative costs. During 2000 the CLO's total operating expenses were approximately $9 million.

The CLO incurs both direct and indirect costs in managing estates. Direct costs, such as a contractor who works exclusively on a particular insurer's estate, are charged directly to that estate each month. Indirect costs are accumulated in a cost pool and are allocated to estates on a monthly basis. Indirect costs generally include administrative and other overhead costs. The CLO categorizes indirect costs as variable or fixed, and it uses different

methods to distribute each type of cost to estates it manages. Indirect variable costs include salaries, wages, and certain professional fees; examples of indirect fixed costs are rent, utilities, and equipment depreciation. The CLO charges its indirect variable costs to each estate in proportion to the number of hours employees have worked on that particular estate in a given month. Indirect fixed costs are allocated in proportion to the number of outstanding claims each estate has.

Of the 54 estates the CLO was managing as of May 2001, 16 were no-asset estates—those without enough assets to cover the CLO's administrative costs and claims. In accordance with the code, the CLO cannot spend the assets of one estate to pay for the costs of another estate, although it does borrow estate funds for this purpose. To cover the costs of managing estates with little or no assets, the CLO is granted an annual appropriation of $623,000 from the department's Insurance Fund. However, the CLO does not receive this appropriation in advance. Instead, it temporarily borrows money from the investment pool to pay the expenses associated with no-asset estates, bills the department for the funds it borrows, and receives reimbursement from the Insurance Fund. The CLO has recently improved its billing procedures to more promptly reimburse the investment pool. In February 2000 the CLO seized two large no-asset title companies and incurred management and other costs of approximately $3.5 million as of May 2000. As a result, the CLO exceeded its Insurance Fund allocation by $3.6 million for fiscal year 1999-2000.

Previous Reports by the Bureau of State Audits

In April 1996 the Bureau of State Audits issued a report titled *Department of Insurance: The Management of Conserved Insurers Has Improved, but Problems With Liquidation and Administration Continue*. The purpose of the audit was to follow up on a May 1994 audit of the department's conservation and liquidation operations with respect to the management of conserved insurers, personnel practices, contracting, allocation of costs to conserved companies, disposition of assets, and claims processing.

During the 1996 audit, we found that the CLO had not adequately monitored its budgets or updated its plans for closing estates. The report also noted that the CLO needed to further improve its administrative practices. Specifically, we found that the CLO did not always follow its policies and procedures for hiring

employees and managing outside contractors. Moreover, we found that the CLO did not always properly allocate its indirect administrative costs to conserved and liquidated insurers.

We recommended that the CLO improve and implement its estate closing plans to maximize the assets of insurers and distribute the assets as early as possible. In addition, we made specific recommendations for the CLO to improve its administrative policies and procedures and to follow them so it could better manage the conserved and liquidated insurers under its control.

The CLO's Reorganization and Staffing

Since our 1996 report, the CLO has experienced high turnover in its executive management. In the past four years, the CLO has had four different chief executive officers. The CLO is currently in the process of reorganizing its operations. Five officers now direct each essential function of the CLO: finance, reinsurance, information systems, claims, and operations. In addition to serving as the second in command, the chief operations officer oversees human resources, administration, and the estate finance managers (formerly called the estate trust managers). In the past, it has been the department's belief that the CLO is not required to follow the administrative procedures used by most state departments. Therefore, the CLO has created its own administrative policies and procedures for managing the activities of conservation and liquidation for the estates in its trust.

In accordance with the department's past interpretation of the code and long-standing case law, the CLO is exempt from budgetary oversight by the Department of Finance, oversight of its expenditures and financial statements by the State Controller's Office, oversight of its contracting and purchasing by the Department of General Services, and oversight of its personnel practices and policies and salary administration by the Department of Personnel Administration and the State Personnel Board. It has been the department's belief that oversight of the CLO's operations is provided by the management of the department; by the superior courts (where conservation and liquidation matters are reviewed); and by the internal and external audits of the CLO, its financial statements, and the financial statements of the estates it manages. Section 1061 of the code requires the Department of Finance to audit the financial statements of the CLO's estates at least every two years and report the results to

the commissioner and the courts. However, the Department of Finance has allowed the CLO to contract for these audits with an independent audit firm since 1994.

The CLO has established 59 permanent positions in its organization that, except for its chief executive officer, are not within the State's civil service system. In addition to permanent staff positions the CLO engages the services of temporary workers, department legal staff, Department of Justice attorneys, private consultants, and private (outside) legal counsel for assistance in conserving and liquidating insurers. Because it considers itself exempt from civil service requirements, the CLO does not establish positions and salaries under State Personnel Board guidelines. Instead, it follows its own policies and procedures, under the supervision of the department, when establishing positions and salaries and hiring and promoting employees.

The Conservation Process

When an insurer is conserved, the CLO works with the department's Conservation Legal Bureau to develop and implement a plan adapted to the insurer's assets and business activities and designed to secure the assets, books, and accounting records of the conserved insurer. After conserving the insurer, the CLO, along with any needed consultants, attempts to determine the causes of the conserved insurer's insolvency or other business problems and its financial condition. The CLO then makes recommendations to the commissioner, who determines whether the conserved insurer can be rehabilitated or whether he should seek a court order to liquidate the insurer's assets. Once the commissioner obtains an order from the courts for liquidation, the CLO develops and implements a plan to liquidate the assets of the insurer and identify its liabilities to policyholders, creditors, and other stakeholders. The CLO also works with its counterparts in other states to secure and sell assets and identify claimants and legal issues related to the insurer's business activities outside California.

After the CLO completes its efforts to identify the claims against the assets of a liquidated insurer, it forwards any covered claims to the applicable insurance guarantee association for processing and payment. Claims not covered by an insurance guarantee association are processed and paid by the CLO from the remaining assets of the insurer. Once an insurer's assets have been

liquidated and the claims liabilities against those assets have been proved by the CLO and allowed by the courts, the CLO makes a distribution of the insurer's assets to pay those claims in the priority sequence detailed in the code. A declaration to the courts that the CLO has complied with the court order for the distribution of assets closes the estate and discharges the responsibilities of the commissioner as liquidator.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits to conduct an audit of the operations of the CLO. Specifically, the audit committee asked us to determine whether the CLO has adequate internal controls to detect the mishandling of the assets of conserved and liquidated insurers. The audit committee also asked us to evaluate the operations of the CLO that are outside the control structure of the State and the sufficiency of the department's efforts to regularly monitor all CLO operations.

To understand the laws governing the CLO, we reviewed the code. We also reviewed the relevant policies and procedures of the department and the CLO.

To assess the sufficiency of the CLO's investment activities, we reviewed its investment guidelines and its compliance with those guidelines by testing a sample of monthly investment reports. In addition, we compared the CLO's rate of return for its investment pool to the benchmark it has selected and to the rate of return the State receives on its Pooled Money Investment Account. We initially tried to review the last 10 years' worth of investment activity; however, the CLO had records covering only the last 5 years. In addition, for 2 of those 5 years, the CLO had five different investment managers. Therefore, to better compare the results of the CLO's investments, we confined our review to the last 3 years. We also evaluated the CLO's investment strategy to determine whether its investment goals adequately match its estate management goals.

To determine whether the CLO appropriately accounts for insurers' assets, we evaluated the adequacy of the CLO's method for allocating investment gains to the insurers' investment pool accounts and tested a sample of allocations. During our review, we found no instances of the CLO inaccurately allocating investment gains to an insurer's account.

To determine whether the CLO avoids using insurers' financial assets inappropriately, we did the following:

- Reviewed the method used to select and compensate the CLO's outside investment managers.
- Interviewed management regarding its implementation of the automated claims processing system it purchased in 1995 and reviewed supporting documentation.
- Evaluated its basis for budgets and its process for reporting on budget variances.
- Evaluated its basis for allocating fixed and variable costs to insurers.
- Reviewed its process for paying the expenses of no-asset estates and billing the Insurance Fund for those expenses.

In addition, to determine the sufficiency of the CLO's management of functions that are outside the State's control system, we evaluated the CLO's processes for executing and monitoring its contracts, for ensuring that it hires the most qualified staff, and for ensuring that its salaries are reasonable and appropriate.

Finally, we evaluated the department's oversight of the CLO's operations. As part of this effort, we examined the work performed by the CLO's internal auditor and analyzed the findings of his operations review. We also assessed the department's role in ensuring that the CLO takes appropriate corrective actions regarding the findings and recommendations of the CLO's internal and external auditors. ■

Blank page inserted for reproduction purposes only.

CHAPTER 1

The CLO Neither Adequately Protects Insurers' Physical Assets nor Ensures That Investment Decisions Are Optimized

CHAPTER SUMMARY

The Conservation and Liquidation Office (CLO) does not follow recommended procedures when it inventories the fixed assets of a company (insurer) that it seizes or places in conservation. In a recent example, rather than immediately completing an inventory to identify and protect the assets of a seized title company, the CLO waited to do so until at least three weeks after it was authorized to take control of the insurer. More recently, the CLO omitted several items from the inventory of a conserved insurer's fixed assets. In addition, the CLO does not account for all of the assets of liquidated insurers after they are auctioned, so it does not know whether the auction company returns all unsold items. Such practices fail to safeguard and conserve the assets that come under the CLO's control.

Because it does not regularly update the individual closing plans for the estates it manages, the CLO is not as effective as it could be in managing insurers' invested assets and budgeting for its operations. Since 1998 the CLO has failed to update its estate closing plans (closing plans). Moreover, it has never included an estimate of each estate's future cash flows in those plans—information that would help its investment managers maximize the assets of the estates they manage. In 1998 the CLO did prepare a cash flow projection for another purpose, but which aided its investment managers. Since then, however, the CLO has neither updated closing plans nor projected its cash flow needs, so this information has been unavailable for making investment decisions or to more accurately budget for its operations.

Finally, the CLO's investment pool has received a slightly higher average return over the past three years than the average return received by the State's Pooled Money Investment Account (PMIA), which is administered by the state treasurer and has similar objectives and makes comparable investments. However, since 1999 when it added the ability to invest in the bonds of

16 foreign countries, the CLO has not reviewed its investment guidelines or performance benchmark to ensure that its investment strategy is appropriate, even though the market value of its investment pool has more than tripled since 1996. In addition, in 2000, the CLO paid $930,000 to its investment managers, but since reducing them in 1998, it has not evaluated the fees it pays to ensure that they are reasonable compared to what other investment firms would charge to manage a pool of similar value. Consequently, the CLO may be spending estate funds needlessly on fees for its investment managers.

In April 2001 the CLO's investment committee agreed to request that the investment managers review the guidelines and consider what changes might need to be brought before the committee. The CLO's investment managers completed their review on July 13, 2001, after the end of our fieldwork. Therefore, we did not evaluate the investment managers' work product.

THE CLO DOES NOT PROMPTLY IDENTIFY AND SECURE ALL ASSETS OF SEIZED OR CONSERVED INSURERS

During our review of the CLO's process for inventorying insurers' assets, we noted several serious weaknesses in its internal controls. For example, the CLO did not promptly complete an inventory of the fixed assets of a seized title company. Fixed assets include items such as vehicles, office furniture and fixtures, computer hardware, copy machines, fax machines, and other office equipment.

Once the CLO obtains a conservation or seizure order, it is important that it take immediate action to identify and secure all the insurer's assets to safeguard against theft or other loss until the court either determines that conservation is not necessary or orders that the insurer's assets be liquidated. When assets are liquidated, they are auctioned and the auction proceeds are to be used to help pay the liquidated insurer's debts.

The CLO had not completed an inventory of assets for one title company for nearly three weeks after the Department of Insurance ordered the company seized.

On February 2, 2000, the department issued seizure orders authorizing the CLO to take control of two title companies. According to the manager of the CLO's administration department, who is responsible for overseeing the inventory process, the CLO began the inventories of the insurers' assets on February 8, 2000. However, he could find no documents to prove the inventories had occurred on that date. Further, during our review of inventory records, we came across an inventory

count sheet indicating that at least part of the CLO's inventory of one insurer occurred on February 22, 2000—nearly three weeks after the date of the seizure order.

According to the CLO's chief operations officer, to whom the administration department manager (administration manager) reports, after receiving authorization to conserve an insurer, the CLO takes immediate action to assume control of the insurer's premises by changing door locks and other security arrangements. In the case of the two title companies, the chief operations officer stated that he understood a decision was made to stagger the timing of the inventories for two reasons. First, because the two title companies were wholly owned subsidiaries of the same parent company and occupied the same premises, the CLO elected to spend time identifying which company owned the assets before taking inventory. Second, the Insurance Code (code) gives the insurance commissioner (commissioner), as conservator, the discretion to defer taking inventory until after a liquidation order is received when an insurer is making a legal challenge to a court-ordered conservation; however, this was not the case for either of the two title companies.

While changing the locks on a seized company's premises is important, it is not a substitute for promptly inventorying assets to safeguard against their loss.

We disagree with the reasons cited by the chief operations officer. According to its policies and procedures, the CLO must immediately place inventory tags on all assets of a seized or conserved insurer. Moreover, we believe it would not be in the commissioner's or the estate's best interests to defer taking an inventory when an insurer has been seized. Seizures are ordered only when there is a strong possibility that assets are being embezzled or diverted or when the insurer is not licensed to conduct business in California and poses a threat to policyholders. Finally, although immediately changing locks and other security arrangements is important, such actions cannot substitute for the CLO promptly inventorying an insurer's assets to fulfill its responsibility of identifying and safeguarding those assets against loss. By not promptly identifying all the assets of a seized or conserved insurer, the CLO fails to ensure that valuable items will not be removed from the premises without its knowledge. Because assets are often later sold at auction and the proceeds used to offset creditors' claims, it is important that the CLO identify and secure all assets as soon as possible after it takes control of an insurer, through either a seizure or conservation order.

We also found that the CLO did not thoroughly count fixed assets during its inventory of a recently conserved insurer. We noted several items that had inventory tags but did not appear

During a recent conservation, the CLO team conducting the inventory neglected to turn in all their count sheets and did not put tags on all items so that they would be included in the count.

on any inventory count sheet, including a refrigerator, a microwave oven, various pieces of furniture, and a television. When we inquired about these items and asked the administration manager about the possibility of some missing count sheets, he stated that he had given us all the sheets. However, after further investigation, the administration manager discovered that some members of the inventory team had not turned in their count sheets. Although the administration manager told us that taking inventory is a routine part of the CLO's work and that the staff assigned to an inventory are familiar with the process, some team members kept their count sheets because they did not know what to do with them after the inventory was completed. The chief operations officer told us that the administration manager would have known which inventory team member had not turned in a count sheet because the inventory tags are sequentially numbered and each team member is assigned a series of inventory tags. Thus, when the administration manager reviewed the count sheets, a gap in the inventory tag numbers would have alerted him to the fact that some count sheets were missing. However, when we asked the administration manager if he routinely reviewed the inventory count sheets to identify gaps in the listed tag numbers, he stated that he did not. If it had not been for our inquiry, the CLO would not have known that all the count sheets had not been turned in.

In addition, we found that some items were not tagged during an inventory. The CLO's policies and procedures manual states that when a conservation order is received for an insurer, the inventory process should account for all items taken into custody. The CLO inventory team is supposed to attach a prenumbered inventory tag to each item counted, and an inventory team member must record a tag number, a description, and, if applicable, a model or serial number on an inventory count sheet for each item. To verify that all items were counted and recorded, team members must double-check the tag on each item.

However, soon after the CLO had completed its inventory of an insurer that was conserved during our fieldwork, we observed several items without inventory tags, including a desk, a marble table, some paintings, and some potted plants and trees. According to the chief operations officer, staff erroneously began their counts on the second day of the inventory in a different area of the insurer's premises, rather than where they had stopped the previous day. The chief operations officer further explained that it is the CLO's informal policy not to count plants and certain other miscellaneous items such as small office supplies, because

these items have little monetary value. However, this informal policy conflicts with the CLO's policies and procedures manual, which states that all assets should be counted. Moreover, we noticed that some plants had tags and others did not, leading us to conclude that at least some inventory team members were confused about what should and should not be tagged during an inventory. We attribute this apparent confusion to the fact that the CLO's written inventory policy does not clearly address miscellaneous items or assets having little monetary value. Moreover, the CLO does not ensure that inventory teams follow uniform procedures when conducting inventories, because team leaders do not adequately supervise and oversee the inventory process. In addition, before starting an inventory, the CLO does not develop and provide each team member with an inventory work plan that includes specific instructions for performing that particular count. Consequently, decisions regarding when to turn in count sheets, what areas to count, and what is considered a miscellaneous item or one of low monetary value are left to each individual team member.

The CLO neither provides its inventory team members with written instructions prior to the count nor ensures that the inventory process is adequately supervised.

Prudent business practices for the inventory of physical assets include holding preparatory meetings to discuss the inventory process and providing the inventory team with written instructions regarding how to conduct the inventory. In addition, the inventory process should be completed promptly, count sheets should be prenumbered to ensure that they are all collected once the inventory is completed, and all items should be checked to ensure that they are clearly marked or tagged.

The CLO's Inventory Policies and Procedures Are Inadequate

Two reasons the CLO's inventory process is problematic is that its inventory policies are outdated and its procedures fail to provide detailed instructions as to how an inventory should be conducted. The CLO's inventory policy, which was last revised in July 1994, designates who is responsible for specific tasks, such as receiving and distributing inventory tags, maintaining a list of tag numbers and a corresponding list of staff who have been assigned a series of tags, and placing tags on assets. The policy also designates who is responsible for completing the inventory count sheets, but neither the policy nor a sample count sheet included in the policy indicates that count sheets should be sequentially numbered. Another reason for the CLO's inventory problems is that its staff are not sufficiently trained in inventory control procedures and may not fully understand their importance. Unless the CLO develops thorough work plans

for each inventory, provides its staff training in the inventory procedures to be used, and makes sure that the procedures are followed, it cannot ensure that it promptly identifies and secures all insurers' assets.

The CLO Does Not Account for All Assets After an Auction

Another internal control weakness we found is that the CLO does not account for all asset items after an auction. In conjunction with its contract with an auction company, the CLO provides the auction company with a list of items to be auctioned, which includes inventory tag numbers. The auction company uses this list to create its own list of items for sale. After the auction, the auction company gives the CLO a list of the items that sold and their selling prices as well as a list of items that did not sell. However, the CLO does not have a process to reconcile its list with those it receives from the auction company. According to the administration manager, when he attends an auction, he uses the auction company's list of items available for auction to check off each item that sells and notes its selling price. However, because he does not compare the auction company's lists of sold and unsold items with the CLO's list of items available for auction, the administration manager cannot ensure that all the items are accounted for.

The CLO has no process to ensure that all items not sold at auction are returned.

Further, we determined that even if the administration manager had attempted to reconcile the auction company's lists to the CLO's list of items available for auction, he would not have succeeded because some items on the auction company's list of sold items did not have a corresponding inventory tag number. We could not determine whether this was because some tags had fallen off or the auction company had not included some tag numbers in its list. In addition, when we attempted to identify some items by comparing the descriptions on the auction company's list to the descriptions on the CLO's list, we were unable to find a match in some cases. For example, a brown side chair that we saw on the CLO's list was not on either of the auction company's lists. Rather, several items on the auction company's sold list were generically described as "chairs." Because the descriptions did not always match, we were unable to identify some items that did not have inventory tag numbers on the auction company's lists. In the CLO's contract with the auction company, the CLO does not specify that each item appearing on the sold and unsold lists must have the same description as appears on the CLO's list of items to be auctioned. Thus, the CLO cannot use the auction company's lists to

determine whether all the items that were available to auction were either sold or returned to the CLO. In addition, we found that some items appeared both on the auction company's list of items sold and on its unsold list. For example, the auction company reported a typewriter and several filing cabinets as being both sold and unsold.

The CLO Does Not Routinely Prepare or Update Estate Closing Plans

For each estate it manages, the CLO does not routinely update closing plans or estimate cash flow needs. As a result, the CLO cannot provide information that would help its investment managers maximize estate assets, and it limits the CLO's ability to accurately plan and budget for its activities. In preparing closing plans, the CLO has developed a set of master procedures that guide how the CLO's estate finance managers conserve and close insurers' estates. Closing plans identify timelines and specify tasks that various units of the CLO and the Department of Insurance's (department) legal staff must perform. Procedures for claims processing and payment, final accounting of estate assets, partial and final distribution of assets, and estate closing are normally included in closing plans. However, the estate finance managers have not prepared or updated any closing plans since 1998 and have never made cash flow estimates part of closing plans. A cash flow estimate would include inflows like reinsurance recoveries and litigation awards and outflows like asset distributions and the administrative cost of managing the estate. According to the chief operations officer, at one time it was the CLO's goal to update closing plans quarterly for all estates it managed. However, because of high management turnover and heavy workloads, the CLO has not prepared closing plans for any estate it has taken over since April 1998, nor has it updated any existing plans since that time.

By not regularly updating its closing plans and including estimated cash flows, the CLO hinders its ability to plan activities and optimize investment decisions.

In 1998 the CLO did prepare a cash flow analysis of all the estates in liquidation for a purpose other than to update its closing plans. According to the chief financial officer, the CLO's investment managers found this cash flow projection useful in managing the investment portfolio. For example, if they knew that the CLO was planning to make a distribution in the next year, the investment managers could optimize their investment decisions so that enough maturing investments would provide the needed cash while earning the maximum return on the portfolio's other investments. Two of the CLO's objectives for preparing closing plans are to maximize the assets of managed

estates and to provide planning and budgeting information on the CLO's operations. When it fails to prepare or update closing plans and cash flow estimates, the CLO limits its ability to measure its success in meeting those objectives.

According to the chief executive officer, the CLO intends to complete closing plans for all estates that do not have one and to update the plans of the remaining estates by the end of August 2001. Once these plans are completed, the CLO will prepare estate cash flow projections and update the plans and projections either quarterly or every six months.

THE CLO MAY NOT KNOW WHETHER ITS INVESTMENT STRATEGY IS APPROPRIATE

The CLO's investment pool earned a slightly higher three-year average return than a state-managed pool that makes similar investments.

Although its investment pool has grown significantly, the CLO has not reviewed its performance benchmark and investment guidelines since 1999 and has not evaluated the reasonableness of the fees charged by its investment managers since 1998. The CLO's investment pool earned a slightly higher three-year average return from 1998 through 2000 than the PMIA earned over the same period—5.94 percent compared with 5.69 percent—even after adjusting the two rates for the payment of investment manager fees. However, the CLO's investment benchmark performed slightly better at 6.01 percent during that same period. The CLO last reviewed its investment guidelines in 1999 when it added the ability to invest in the bonds of 16 foreign countries; however, the guidelines still may not be appropriate for the CLO's current situation. For example, the market value of the investment pool totaled $275 million in January 1996. Significant growth occurred in September 1998, when assets from a large estate totaling approximately $766 million were transferred into the investment pool. Consequently, the market value increased from $323 million to $933 million, which is net of the distributions made that month. As of May 2001 the market value of the investment pool was $916 million, and it is currently managed by two of the five investment managers who managed the pool in 1996. Moreover, the last time the CLO evaluated its investment managers' fees to determine whether they were still reasonable was when it reduced them in February 1998. In 2000 the CLO paid $930,000 in management fees without knowing whether this amount was reasonable compared to what other investment managers would charge to manage a pool of similar

The CLO has not recently done a fee comparison among investment firms to verify it is receiving the best results at the lowest cost.

value. As a result, the CLO may be paying higher administrative fees than it otherwise would to obtain a comparable return and may be needlessly expending estate funds.

The objectives of the PMIA are to ensure the safety of the investment portfolio by investing in high-quality securities; make certain that the goals of safety, liquidity, and yield are not jeopardized; and prudently manage the investment pool. The PMIA makes investments similar to those in the CLO's investment pool. Like the PMIA, the CLO has set investment objectives of maintaining the safety of the principal and maximizing available yield while minimizing risk through an investment portfolio based on quality and diversification. Accordingly, the CLO's investment guidelines require safe investments, such as high-quality corporate bonds, and they outline the types of investments that are permitted, such as U.S. government securities, as well as investments that are prohibited, such as emerging market instruments. Based on these objectives and guidelines, the CLO selected a benchmark to define its investment strategy and measure its performance. The benchmark it chose was an index based on low-risk government and corporate investments. Because the investment pool replicates the composition and performance of the selected benchmark, the benchmark may preclude it from maximizing the return on investments.

Because the investment pool's average value has changed significantly over the past five years, and because the CLO has not recently evaluated its investment managers' fees, the CLO cannot be certain that its guidelines and benchmark are still appropriate for managing the assets of the investment pool and are maximizing its earning potential.

RECOMMENDATIONS

To ensure that it adequately safeguards the fixed assets of insurers under its control, the department should require the CLO to take the following steps:

- Develop work plans for each inventory it conducts, based on prudent business practices that include the following:
    - Holding preparatory meetings to discuss the inventory process.

- Providing an inventory work plan that includes instructions regarding how each inventory will be conducted.
- Promptly conducting and properly supervising inventory counts to reduce the risk of loss.
- Ensuring that all count sheets are prenumbered and collected after the inventory is complete.
- Checking all counted items to ensure that they are clearly marked or tagged to avoid omitting any.

- Train its staff in proper inventory procedures and require all personnel who participate in the inventory process to follow the new procedures.
- In its contracts with auction companies, require auction lists of sold and unsold items to include the inventory tag numbers and the same descriptions as included on the CLO's list of inventory available for auction, and reconcile the lists to ensure that all inventoried items are accounted for.

To maximize the return on the assets it manages, the department should ensure that the CLO takes the following actions:

- Create or update closing plans that include estimates of the future cash needs for each estate. The CLO should use this information to ensure that it reaches its goal of maximizing estate assets and to accurately plan and budget for its operations.
- Periodically reevaluate its investment strategy and benchmark to reflect changing conditions and requirements.
- Periodically review its contract for investment management services to determine whether the fees it pays are reasonable compared to what other investment managers would charge to manage an investment pool of similar value. n

CHAPTER 2

The CLO Has Poor Practices in Place to Conserve Assets of Estates It Manages

CHAPTER SUMMARY

The Conservation and Liquidation Office (CLO) suffers from poor management practices in several areas, many of which we have previously reported. For example, we found that the CLO does not ensure that contract managers follow its competitive bidding policy, which specifies only three circumstances when obtaining competitive bids is not required. Two of the 10 contracts we reviewed should have been competitively bid but were not, and the reasons the CLO gave for using sole-source contracts did not appear to qualify as exceptions as defined in its policy. We also found that the CLO does not ensure that it hires and promotes the most qualified applicants. For example, the CLO hired two applicants and promoted one employee who did not appear to meet the CLO's minimum qualifications. In addition, we found that the CLO has not evaluated the structure of its salary ranges since 1995 and has never had comprehensive conflict-of-interest policies and guidelines for its employees and vendor contractors to follow. When the CLO fails to properly control and monitor its contracts, does not ensure that it hires the most qualified staff, and does not guard against potential conflicts of interest, it may spend estate assets improperly or unnecessarily.

Our audit also revealed inequities in the CLO's basis for allocating its fixed costs to the estates of insurers it manages. Moreover, the CLO does not regularly review the status of estates to identify those that meet its criteria for sharing fixed costs. For example, we found that for one estate, the CLO did not allocate more than $4,000 for one month's fixed costs, despite staff spending 94 hours working directly on this estate's activities.

Finally, although the CLO has spent more than $5.7 million to implement the claims processing system it purchased in 1995, the claims system continues to be costly and inefficient, and it does not effectively support the CLO's operations. For example, although the processing system was purchased in part to improve

the CLO's reinsurance claims process, reinsurance recovery claims continue to be handled manually—a process that is inefficient and prone to error.

THE CLO DID NOT ALWAYS FOLLOW ITS PROCEDURES FOR AWARDING AND MANAGING CONTRACTS FOR PROFESSIONAL SERVICES

In our previous report dated April 1996, we found that the CLO did not consistently follow its procedures for awarding and managing contracts for professional services. For example, the CLO did not always seek competing bids for consulting contracts, made payments to contractors that were not in strict accordance with contract terms, and paid invoices that did not contain the required detail of contractors' expenses. Apparently, the CLO has not yet addressed these issues because our review of 10 contracts in effect as of or after January 1998 revealed similar examples of poor contracting practices.

Sometimes the CLO Did Not Seek Competitive Bids

In 2 of 10 cases, the CLO should have sought competitive bids but did not.

Of the 10 contracts we reviewed, the CLO should have sought competitive bids for 2 but did not. The CLO's policy for entering into sole-source contracts greater than $10,000 lists three circumstances when competitive bids are not required: in emergency situations, when the contractor possesses unusual or unique skills, or when the contracted services are needed in a remote geographic area.

In the first case involving an unjustified sole-source contract, the CLO inherited from the department a contract for financial and claims services on one insurer's estate. The Department of Insurance (department) had established this contract in May 1992, while it was managing the estate. Beginning in July 1997, the CLO continued to use the contractor's services under the original agreement until finally executing a new contract in January 2000. The contract manager stated he did not seek competitive bids for this contract because the contractor possessed knowledge of the insurer's operations. Further, the CLO had previously used the contractor's services and was satisfied with the contractor's prior performance. In the second case, the CLO did not seek competitive bids before awarding a contract for arbitration services. Rather, according to the CLO's chief executive officer, the decision was based on a recommendation made by one of the CLO's outside

legal counsels. The CLO's reasons for executing both these contracts do not seem to qualify under the CLO's policy for sole-source contracts.

Further, we found that the CLO continues to renew two other contracts periodically without seeking competitive bids for the services. The managers for these contracts told us that they had contacted a few other vendors by phone regarding their rates for services. However, we could not corroborate the contract managers' assertions because neither of them documented their discussions with these vendors or their analyses of vendor rates. Without such documentation, we could not verify that the CLO is receiving the best rates for the services it purchases under these repeat contracts.

In a previous audit, we reported that the CLO had developed procedures for professional service contracts that were modeled, in part, on the consulting contract requirements of the Public Contract Code and the State Administrative Manual. Although the CLO's contract procedures include such critical elements as obtaining proper approval for contracts and providing detailed descriptions of the services that are being contracted for, they do not provide clear guidance in some important areas. For example, the procedures do not specify when a formal bidding process, called a request for proposal, should be used and when a less formal telephone bidding process is acceptable; nor do they stipulate what documentation is necessary in those instances. In addition, although the procedures list three circumstances in which noncompetitive bidding is allowed, the wording is vague and open to interpretation; for example, the CLO policy allows sole-source contracting in "emergency situations" without defining specific situations. Therefore, the CLO relies on the judgment of its department managers to determine when competitive bids are required and what type of bid process they should follow. The CLO is in the process of amending its contracting procedures; however, the new procedures still do not specify when managers should issue requests for proposals for outside service contracts, or when using a telephone bidding process is appropriate and how to document that process.

The CLO's contract procedures do not provide guidance for when a formal bidding process is required or the documentation needed when using a less formal telephone bidding process.

Contract Managers Do Not Adequately Monitor Their Contracts

We also found that the CLO does not always ensure that its contractors adhere to the terms and conditions of their contracts, because contract managers are not always aware of what the

terms and conditions are. For example, we found that one contract required the contractor to provide detailed records of the hours its personnel worked under the contract and have a CLO representative certify that the hours were correct and the work was satisfactory. However, the CLO has not enforced this requirement. In fact, the contract manager was not even aware of the requirement until we brought it to his attention. Without adequate time records, contract managers cannot ensure that the invoices contractors submit for payment accurately reflect the time spent on contracted work.

Two contract managers were unaware of some of the terms included in the contracts they were responsible for managing.

In another example, we found that although one contract specifies that the CLO will pay the contractor on full and final completion of the contracted work, the CLO has paid for services whenever the contractor submitted invoices. The contract is for actuarial services for certain insurers' estates that the CLO currently administers. The contract manager told us that he was not aware that this provision for payment was in the contract until we pointed it out to him. However, he stated that the contract's provision for payment should be changed because it is not reasonable to wait until the end of the contract period to pay the contractor for these services.

In addition, we noted two instances in which the CLO continued to receive and pay for services after the contracts had expired. In one instance, the CLO failed to renew a contract for security services that had expired at the end of January 2000 but continued to pay the vendor even after accounting personnel notified the contract manager of the expiration. As a result, it paid more than $486,000 to the vendor over a period of more than 11 months without having a contract in place. When the CLO finally executed another contract for the same services in January 2001, it was able to negotiate a $39 hourly rate for a specific type of security service rather than the $50 hourly rate it had been paying. However, the CLO backdated the term of service in the new contract to cover services it had been receiving from this vendor since mid-September 2000 and made the term effective to mid-September 2001. Further, the new contract stated that if it were executed after September 15, 2000, its terms and conditions—including the lower rate—would be retroactive to that date. The CLO, therefore, not only paid a higher rate for the services it received while no contract was in place than it had negotiated under the new contract, but according to the contract's terms, it also overpaid this vendor more than $43,000 for the backdated portion of the new contract and about two weeks after it was signed. Moreover, despite backdating the term

The CLO overpaid one contractor more than $43,000.

of service and retroactively applying all of the terms and conditions of the new contract, the CLO did not seek a refund for the overpaid amount. According to the contract manager, seeking a refund from the vendor would not be appropriate. We disagree. As shown in Figure 1 on the following page, if the CLO had promptly executed a new contract when the previous one expired and had negotiated the same hourly rate, rather than overpaying the contractor by more than $43,000, it could have saved nearly $142,000 in insurer assets.

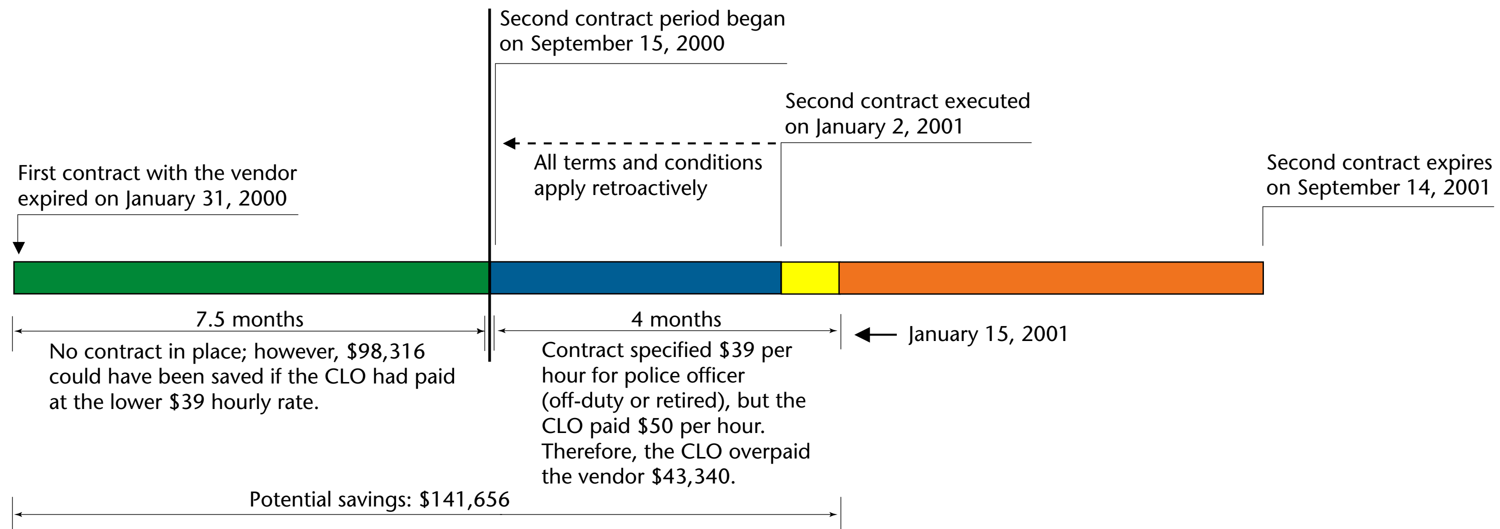
In another instance, the CLO continues to pay a contractor for claims and financial services without having a contract in place. Although the contract expired on December 31, 2000, the CLO has not renewed it despite its ongoing need for the services. As of May 2001, the CLO had paid almost $63,000 for services it received after the contract expired.

The CLO's contracting procedures require contract managers to review each invoice to ensure that the rates comply with contract terms and that it does not pay for services it did not receive. However, in all of the instances just described, we determined that the contract managers had not periodically monitored the contracts for which they were responsible to refresh themselves on the contracts' terms and conditions and to determine if and when they should renew them. Instead, the contract managers relied on accounting personnel to notify them when problems arose with invoices and when a contract had expired and required renewal. Moreover, contract managers frequently ignored instances when accounting staff advised them that a contract had expired or that an invoice did not reflect the terms of a contract. By allowing contractors to perform services without valid contracts in place, the CLO does not ensure that it receives quality services at the stipulated prices and hinders its ability to enforce compliance with unwritten contract terms and conditions.

The CLO's contract procedures also require the contract managers to review the amount paid under a contract to ensure that the contract budget is not exceeded. Contract managers are required to obtain the approval of a member of the CLO's senior management before exceeding the amount of a contract. However, we found that the CLO has not been following these controls because it does not assign each contract a unique number for its contractors to use when billing for services under a specific contract. This process would allow the CLO to compare the aggregate payments made under a given contract before approving any additional invoices for payment and would

FIGURE 1

Chronology of the CLO's Payments for Security Services



Source: CLO contract records.

guard against overpaying the contract limit. The CLO's accounting system tracks invoices by vendor number instead of contract number. Under its current process, the CLO's contract managers do not receive information on how much has been expended on a particular contract, and they do not keep their own records of this information. Instead, they rely on the accounts payable manager to notify them when actual expenses are likely to exceed a contract budget. Therefore, when the CLO enters into more than one contract with a vendor, which is often the case, payments could be applied to the wrong contracts or the total paid to a particular contractor could exceed the applicable contract limit, and estate assets could be wasted.

THE CLO DOES NOT ENSURE THAT IT HIRES AND PROMOTES QUALIFIED STAFF

The CLO hired two employees and promoted another that did not appear to meet the minimum qualifications for their respective positions.

The CLO does not ensure that its employees meet the minimum qualifications to perform their duties, nor does it check references or verify the education records and employment histories of applicants before making hiring decisions. The CLO has developed minimum qualifications specifying the relevant educational degrees and the length and type of work experience required to successfully perform the functions of each position. It has established salary ranges for each position that are structured to compensate individuals who qualify for the position. We compared the minimum qualifications for the positions held by seven employees to the information they had provided on their résumés and job applications. During our review, we found that two of the seven employees were hired even though their information suggested that they did not meet the minimum qualifications required to perform the duties of their respective jobs. One of these two employees was hired at a starting salary that exceeded the midpoint of the salary range. In addition, in our review of employee documents, we found that one employee was promoted despite not having the associate degree and specific technical knowledge and experience the position required. In addition, the CLO did not document its justification for hiring or promoting staff who did not appear to meet its minimum requirements. We reported a similar weakness in the CLO's hiring practices in 1996.

The CLO does not verify information, such as college degrees and work experience, listed by applicants on their résumés and job applications. According to the chief operations officer, the CLO's regular hiring practices do not include verification of

college degrees and prior work experience, although the minimum qualifications for some positions require bachelor's degrees and/or specific levels of experience to successfully perform the job's functions. Consequently, the CLO cannot be certain that it is employing the most qualified personnel, and it may be compensating some employees for qualifications they do not possess.

THE CLO IS NOT SURE THAT ITS SALARY LEVELS ARE STILL COMPETITIVE

The CLO has obtained market data on salary trends, but it has not used the data to evaluate and adjust its salary structure since 1995.

According to the chief operations officer, a combination of heavy workloads and inconsistent leadership has hindered the CLO's efforts to evaluate the structure of its salary ranges since it last did so in 1995. For example, the chief operations officer stated that when insurers are initially seized, conserved, or liquidated, the CLO's resources are particularly strained. During the early months of the conservation and liquidation processes, some members of the CLO's management team work off-site while also trying to manage some of the daily operations at the office. As a result, the CLO's management has not had the resources to focus on issues like evaluating whether its salary structure is reasonable and competitive.

Since 1994 the CLO has had four chief executive officers. The chief operations officer stated that these leadership changes have prevented the CLO from developing and implementing a strategic plan, which would include a salary structure evaluation. Although the CLO has obtained market trend reports for salary scales, it has not considered and evaluated this data. As a result, the CLO has not adjusted its structure for salary ranges since 1995. When the CLO does not periodically evaluate its salary structure, it cannot be sure that its salaries are reasonable and remain competitive enough to attract and retain qualified applicants.

THE CLO HAS NEVER ESTABLISHED A COMPREHENSIVE CONFLICT-OF-INTEREST POLICY FOR ITS EMPLOYEES AND CONTRACTORS

Because CLO employees and contractors are frequently privy to sensitive financial and other information concerning insurers, the CLO has a responsibility to ensure that its employees and contractors are free of any impairments that could bias the decisions they make in administering insurers' estates. However, the CLO has never established conflict-of-interest guidelines that

define specific conflicts of interest and incompatible activities or that give guidance on the acceptance of gifts. Without such a policy, a CLO employee who makes key decisions regarding how estates are managed could, for example, hold an ownership interest in a managed insurer's estate or in a competing insurance company without disclosing such information. Because it lacks comprehensive conflict-of-interest policies and guidelines, the CLO cannot ensure that its employees and contractors adequately safeguard sensitive information and act in the best interest of the estates it manages.

As a state agency, the department requires designated employees to complete annual statements disclosing their financial interests. However, because the CLO's employees are not state employees, except for its chief executive officer, the CLO does not require them to make such disclosures. Before 1999 the CLO required all employees to sign an annual conflict-of-interest certificate that, according to the chief operations officer, constituted the CLO's conflict-of-interest policy. However, the certificate was merely a retrospective questionnaire and did not provide overall guiding principles regarding conflicts of interest, nor did it clearly define what constitutes incompatible activities or give guidance concerning acceptance of gifts and protection of sensitive information. Moreover, the CLO has not required its employees to sign an annual conflict-of-interest certificate since 1998. Beginning in 1999, the CLO has attempted to develop and implement a comprehensive conflict-of-interest policy. The most recent draft of the policy provides detailed guidelines regarding some incompatible activities, acceptance of gifts, and employee investment activities. However, the draft policy does not give guidance on what constitutes conflicts in the daily decision making of the CLO's employees. Further, the CLO has yet to finalize and implement this conflict-of-interest policy.

Without clear guidance on the types of activities that may be incompatible with their duties, the CLO is not assured that its employees are making decisions that are free from bias.

The department's legal bureau, which manages the CLO's contracts for outside counsel, has adequate conflict-of-interest guidelines and policies to ensure that the outside counsel discloses actual and potential conflicts of interest. All other contracts under the CLO's direct management contain standard language requiring contractors to adhere to the CLO's conflict-of-interest policies. However, according to the chief operations officer, those policies do not currently exist. Until a conflict-of-interest policy is finalized and approved, the CLO will continue to rely solely on each employee and contractor's judgment and knowledge in identifying and avoiding any incompatible activities they may have and fully disclosing any conflicts of interest.

THE CLO'S BASIS FOR ALLOCATING FIXED COSTS UNFAIRLY BURDENS SOME INSURERS

The CLO's method of allocating its fixed costs—such as the costs of office space, storage, equipment, and computer systems—among the insurers under its management is inequitable. The method involves calculating the number of proofs of claim (a document that claimants are required to file in order to receive payment from either an insurance guarantee association or from an insurer's estate) associated with each insurer as a percentage of the total and then allocating its fixed costs to each insurer based on that percentage. Using this method, the CLO overly burdens some insurers and does not charge anything to other insurers whose estates the CLO manages using staff and resources. Between January 1, 2000, and March 31, 2001, the CLO allocated $2.7 million in fixed costs to 22 insurers with proofs of claim, out of an average of 52 insurers that it actively managed during that time. Thus, less than 50 percent of the insurers the CLO managed paid all the CLO's fixed costs, despite all insurers sharing in one or more of the benefits provided by the office space, storage, or computer services used by staff in managing the estates.

According to the chief financial officer, the CLO developed its method of allocating fixed costs several years ago and prior to his being hired. It is his understanding that the CLO used proofs of claim to allocate fixed costs because its managers reasoned that employees would still need to record and maintain proofs of claim whether or not they did any other work on a given estate. Therefore, the fixed cost of infrastructure items such as equipment and facility costs were generated to support the CLO's proofs of claim activities.

The CLO continues to use proofs of claim as a basis for allocating its fixed costs to the estates, even though this allocation method is inequitable.

However, there are some flaws in the logic of using the number of proofs of claim as the basis for allocating fixed costs. Specifically, one insurer can have few proofs of claim that are very complex and require a significant amount of work while another insurer can have thousands of proofs of claim of a more routine nature that require little work. For example, a proof of claim filed by an asbestos manufacturer who has had claims made against it by hundreds of claimants who used the asbestos product will require more research and possibly involve litigation compared to a proof of claim filed for automobile damage caused by a driver accidentally backing into a telephone pole. Because the amount of staff work that an insurer's proofs of claim require is related to the nature of the claims rather than to

their volume, by using the number of proofs of claim to allocate fixed costs, the CLO unfairly burdens some estates by allocating them a greater portion of fixed costs than they should receive.

Moreover, for some months the majority of estates managed by the CLO have no proofs of claim, yet the majority of the CLO staff's hours are charged to the estates with no proofs of claim. This happens because some of the CLO's work is unrelated to activities associated with proofs of claim. For example, during the first few months after the CLO takes over an insurer, most of its staff's effort is devoted to identifying and taking control of the insurer's physical and financial assets, records, books and other property, and collecting on existing reinsurance receivables—tasks that are not related to the proofs of claim that are filed against the estate or their volume. Further, because most proofs of claim are related to insurance policies issued by a now insolvent insurer, they are processed and paid by an insurance guarantee association (IGA), not by the CLO. However, once the IGA has processed and paid a proof of claim, the CLO's work on the estate shifts to reviewing the IGA's work—a task that is closely related to the proofs of claim. Consequently, when using the CLO's current method for allocating fixed costs, an estate with proofs of claim will bear a certain portion of each month's fixed costs regardless of whether any proofs of claim work was done in a given month because the allocation is driven by their number, not the level of work activity associated with the estate as a whole.

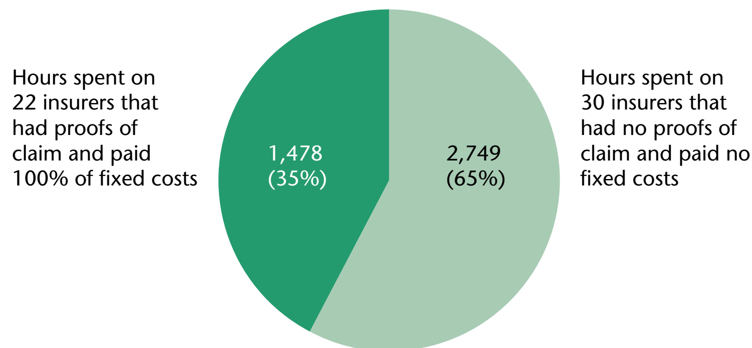
The CLO claims officer informed us that although an insurer might have proofs of claim that remain outstanding for years, the CLO staff will not necessarily be actively working on that insurer the entire time. As a result, the CLO's method of using proofs of claim to allocate fixed costs is flawed and is unfairly burdening insurers that have large numbers of outstanding claims by making them pay a disproportionate share of these costs.

We believe that the CLO could allocate its fixed costs to insurers based on fairer methods that more closely reflect the insurers' share of those costs. For example, it could use a method similar to the one it uses for variable costs such as employee salaries. The CLO compiles the number of hours its staff members work directly on a given insurer each month and allocates its variable costs based on those hours. This would be a fairer method of allocating fixed costs because the number of hours spent also reflects the share of office space and furniture and fixtures being devoted to managing the insurer.

For instance, in February 2001, the CLO staff spent approximately 4,227 hours working directly on the estates of 52 insurers. As Figure 2 shows, the staff spent only 35 percent (1,478) of those hours working on the 22 insurers with proofs of claim. Moreover, the CLO allocated 100 percent of the $186,130 in monthly fixed costs to the 22 insurers, including almost $55,900 to one insurer that did have more than 30 percent of the total proofs of claim that month but required only about 22 hours of the CLO staff's time. In that same month, the CLO did not allocate more than $4,000 in fixed costs to another insurer that had no proofs of claim, despite the fact that CLO staff spent 94 hours working directly on this insurer's estate.

FIGURE 2

Staff Hours Spent on Insurers With and Without Proofs of Claim in February 2001



Source: CLO accounting records.

THE CLO DOES NOT REGULARLY REVIEW THE STATUS OF INSURERS TO ENSURE THE FAIR ALLOCATION OF FIXED COSTS

Each month the CLO's claims unit reports to the accounting unit the number of proofs of claim for the insurers it is managing so that it can allocate fixed costs to those insurers. According to the claims officer, the claims unit reports the number of claims outstanding only for those insurers with sufficient assets to pay for allocated costs, based on information received from the CLO's estate finance managers.

However, the estate finance managers do not review all insurers regularly to ensure that the ones with sufficient assets to pay for their share of the fixed costs are included in the monthly list and that the ones with insufficient assets are not included. Without a process to review the assets of all insurers regularly, the CLO faces a potential for under- or over-allocating fixed costs to insurers. As we discussed in the previous section, using proofs of claim as a basis for allocating fixed costs may not be equitable. In addition to this fundamental inequity, we found that the CLO does not have a process to ensure that it identifies and allocates a portion of its fixed costs to all estates that meet its criteria for sharing them. For example, we found that the CLO has not charged any fixed costs to one insurer despite its having sufficient assets and at least 4,663 proofs of claim outstanding since December 1999.

When we inquired about this case, the chief financial officer explained that in December 1999, the majority of the CLO's fixed costs were for its claims processing computer system. However, the insurance company in question had its own claims processing system, which it still uses, so the CLO did not use its system to manage the insurer. In addition, until late 1999, first a special deputy appointed by the insurance commissioner and then the CLO managed the operations of this insurer at a separate location outside the CLO, and the administrative costs involved (both variable and fixed) were paid entirely by the insurer. Consequently, the CLO decided not to allocate fixed costs to the insurer. Although we agree with this reasoning, in December 1999, the management of this insurer was moved to the CLO. Since then, the insurer has received the benefits provided by such fixed costs as the CLO's office space and equipment without paying for them. Therefore, under the CLO's current method of allocating fixed costs based on proofs of claim, this insurer should have paid $58,174 since January 2000. If the CLO based its fixed-cost allocation on staff hours spent working directly on each estate—a method we believe is fairer, as previously discussed—it should have allocated $190,156 to this insurer since January 2000.

The CLO exempted one insurer from incurring any allocated fixed costs even though under the CLO's method of allocating such costs the insurer should have paid $58,174.

The chief financial officer also argued that because of the substantial number of claims against this insurer, it would be unfair to allocate any fixed costs to it based on proofs of claim. We agree with the chief financial officer's argument, which only underscores our previous conclusion that the CLO should consider other methods of allocating fixed costs that are more equitable than its current method.

THE CLO SPENT MILLIONS IN ESTATE ASSETS TO IMPLEMENT A CLAIMS PROCESSING SYSTEM THAT DOES NOT EFFECTIVELY SUPPORT ITS OPERATIONS

The CLO is responsible for administering and processing proofs of claim (claims) for the insurers under its management. In October 1995 the CLO purchased a new automated claims processing system to centralize and more effectively manage its claims. However, the CLO failed to adequately identify its claims processing needs before purchasing the system. As a result, the CLO purchased a claims processing system that was not designed to handle the complex nature of its claims and has since required extensive modifications. Despite a four-year, $5.7 million implementation effort, the CLO uses its system to process claims for only nine estates, and it is considering abandoning the system altogether. While the CLO is considering other options, the claims processing system continues to be costly, inefficient, and does not effectively support its operations.

The CLO implemented its new claims processing system in September 1999, nearly four years after having purchased it. According to the CLO's chief information officer, the system was originally designed to process claims for a standard insurance company. However, unlike a standard insurance company, the CLO must process and administer a variety of claims made against liquidated estates, not just claims made against insurance policies. For example, the CLO must also process claims for administrative expenses such as rent payments, legal fees, and vendor services associated with the estates it manages. Because the system was not originally designed to handle claims that are as complex and varied as the ones the CLO works with, the CLO contracted with an information technology consultant to help it develop system requirements, testing, and data conversion efforts at a significant cost.

CLO Claims Processing System Implementation Costs (October 1995 to September 1999)

Item	Cost
Purchase price	**$400,000**
Ongoing system costs	**$1,252,280**
Maintenance	
System modifications	
Technical support	
IT/management consultants	**$1,634,398**
System specifications	
Acceptance testing	
Data conversion	
Permanent/temporary employees*	**$2,449,635**
Acceptance testing	
Data conversion	
Total	**$5,736,313**

* Costs from October 1995 to March 1998.

Initially intending to convert claims information for 5 estates, the CLO later expanded that number to 8 with the goal of eventually adding to the system all newly liquidated estates that had assets and were subject to the claims process. Since purchasing its new claims processing system in October 1995, the CLO has conserved 14 estates, of which 9 have sufficient assets and are suitable candidates to pay claims

and, therefore, justify the CLO's converting all claims information onto the claims processing system. As of June 2001, the CLO was using its system to process claims information for only 1 of the 9 estates. Another 5 are subsidiaries of a parent company (noninsurance) in bankruptcy. For these estates, the CLO uses the system to store some claims information but not to process claims. According to the chief information officer, the CLO uses the insurers' systems to process claims because the CLO does not have sufficient resources to handle the volume and complexity of the claims for these 5 estates. The CLO is currently considering whether to store some claims data on its system for the 3 remaining estates, all of which were conserved in 2001. Claims for the other estates that the CLO manages are processed on a variety of systems, including its old claims processing system and the systems of the estates it has taken over.

Despite costly and extensive system modifications, the CLO's claims processing system is still unable to efficiently process the CLO's claims information. Because of a variety of problems with the claims data, such as the amount and accuracy of the data that was available when the CLO first conserves an estate, the CLO's ability to use its system to process claims for the eight original estates is limited.

Further, the claims system does not produce a full array of standard reports. According to the chief information officer, over the years, programmers from the CLO were able to develop standard reports for the claims department. However, depending on the nature of the request, whenever users other than the claims department need a report, they must ask programmers to specially develop them. Moreover, although the claims system was purchased in part to improve its reinsurance process, the CLO has had to continue its inefficient manual processing of its reinsurance claims. As we discuss in the next section, if claims are not designated as reinsured and identified as a receivable in its accounting system, the CLO cannot attempt to recover reinsurance receivables related to those claims.

The CLO continues to pay costly maintenance and technical support fees for a claims processing system it acknowledges does not meet its overall needs.

The claims processing system continues to drain the assets of the CLO's estates. Since implementing the system in September 1999, the CLO has paid more than $322,000 in system maintenance and technical support fees alone. The CLO acknowledges that its system does not meet its overall claims processing needs. According to the chief executive officer and the chief information officer, the CLO is in the process of reevaluating its overall system needs regarding claims and reinsurance processing.

THE CLO'S PROCESSING OF REINSURANCE CLAIMS IS INEFFICIENT AND INEFFECTIVE

As part of its task of conserving or liquidating an insurance company, the CLO must determine whether any reinsurance contracts exist. Under a reinsurance contract, an insurance company pays a percentage of the premiums it receives from policyholders to another company, called a reinsurer. The reinsurer then assumes an agreed-on percentage of the original insurance company's risk. Reinsurance contracts allow insurance companies to reduce their exposure to risk from policyholder claims. For example, when an insurance company receives a claim from a policyholder, it bills the reinsurer for a portion of the claim, depending on the terms of the reinsurance contract. Receivables associated with an insurance company's reinsurance contracts thus are treated as an asset.

In managing insurers that are being conserved or liquidated, the CLO seeks reimbursement from reinsurers for estates that include reinsurance contracts. In these cases, after the CLO approves and settles claims, it bills the reinsurer for the percentage of the claims specified in the reinsurance contract. The CLO's unaudited financial statements for 2000 indicate that reinsurance receivables net of an estimated uncollectable amount make up approximately $999 million (41 percent) of the estate assets that the CLO manages. Once it collects on reinsurance contracts, the CLO credits the reinsurance payments it receives to the appropriate insurer's estate. The CLO can use the funds later to pay the insurer's creditors.

The CLO does not ensure that all reinsurance receivables are promptly identified, billed, and collected.

The CLO's practice of processing most reinsurance claims manually is inefficient and prone to error. For example, a supervisor in the CLO's reinsurance department retired before he completed the billing process for a $900,000 reinsurance claim. The supervisor had sent the reinsurer a letter informing it that the CLO had all the information necessary to prepare a request for payment but never followed up by sending a bill, which the reinsurer required before it would authorize the payment. In addition, the supervisor had not set up a receivable for the $900,000 in the CLO's accounting system. Consequently, the CLO was unaware that this amount was owed until almost three months later, when the reinsurer notified it that they had not paid the claim. When the CLO's reinsurance department generates a reinsurance bill, the reinsurance supervisor is responsible for setting up a receivable in the CLO's accounting system. However, because most of these claims are processed manually, this is not done

automatically. Unless the CLO properly accounts for all its reinsurance contracts and establishes receivables for all amounts due, it cannot ensure that it bills for all the reinsurance it is entitled to and promptly collects payments owed. This, in turn, causes the CLO to lose interest earnings because of delayed reinsurance payments, and provides fewer funds to pay the insurance companies' creditors.

In one case, the CLO took nearly five months to review and approve a reinsurance claim from another state's IGA. Although the reinsurance manager agreed that an automated reinsurance claims processing system would improve the CLO's current system of processing reinsurance claims, he stated that such a system would not have prevented the delay in processing this specific claim. An IGA guarantees insured customer claims against insurers that subsequently become insolvent, up to statutory dollar limits, depending on the type of insurance involved. When a licensed insurance company goes into liquidation, the IGA pays covered claims up to the specified amount. In this case, an out-of-state IGA had paid on a claim for an insured party and subsequently notified the CLO of the payment. The IGA then sent the claim to the CLO for review. However, after the CLO received the claim, it took two months to recommend an amount to bill the reinsurer and almost another three months to approve the amount. Moreover, as of June 2001, the CLO still had not billed the reinsurer because, according to the reinsurance manager, the $950,000 amount that the CLO's claims department had recommended and the chief executive officer had approved did not include approximately $435,000 in expenses that may be recoverable through the reinsurer. When reinsurance claims are not processed promptly, the CLO loses potential interest earnings and delays potential distributions to creditors.

RECOMMENDATIONS

To ensure that it does not squander insurers' assets, the department should see to it that the CLO takes the following steps:

- Amend its contracting policies and procedures to define when and how managers should seek competitive bids, including the type of documentation required for bids obtained by telephone, and ensure that its contract managers understand and adhere to the CLO's contracting policies and procedures.

- Ask the vendor who provided security services to pay back $43,340 in overpayments due to the CLO paying a higher $50 hourly rate when its contract specified a $39 hourly rate.

- Assign each contract a unique number and require its contract managers to track payments made under each contract they manage and its accounting staff to account for the payments, using a spreadsheet or other means as a control against misapplied payments or overpayment.

- Periodically review contracts to determine if and when they should be renewed and require contractors to adhere to all contract terms and conditions.

- Ensure that it is hiring qualified applicants and promoting qualified employees to positions requiring technical knowledge and experience. The CLO should also verify applicants' references, including work and education records, before making hiring decisions and should document its justification when hiring applicants and promoting employees who do not meet minimum qualifications.

- Evaluate its salary structure, using both private and public sector comparisons, to ensure that it attracts and retains qualified employees.

- Finalize, approve, and implement a conflict-of-interest policy similar to the policy used by state agencies. Further, the CLO should require all designated employees and multiyear contractors to complete an annual conflict-of-interest statement.

- Review other options for allocating fixed costs to insurers that are more equitable than its current method, and implement a method that allocates fixed costs to all insurers' estates with assets that benefit from these costs.

- Develop a system of review to ensure that insurers that should be paying a portion of the fixed costs are included in its allocation process and that insurers that should not be included are not paying these costs.

- Work diligently toward defining its overall claims processing system needs. In the event that it chooses to purchase a new claims processing system, the CLO should explore the option of

alternative procurement, whereby the software company would have a direct financial stake in the successful implementation of the claims system.

- Ensure that reinsurance claims are both properly accounted for and promptly billed. n

Blank page inserted for reproduction purposes only.

CHAPTER 3

The Department of Insurance Must Strengthen Its Oversight of the CLO

CHAPTER SUMMARY

Historically, the Department of Insurance (department) has considered its Conservation and Liquidation Office (CLO) to be exempt from several components of the State's control system, but the department has failed to take the steps necessary to otherwise oversee the CLO's activities. For example, although the CLO's internal auditor acts as the department's oversight arm, the department does not require the internal auditor to adhere to state law and the department's policy that requires a two-year internal audit cycle. In fact, the current audit plan does not have the internal auditor completing his first audit cycle until 2002—nearly five years after its start. Consequently, the internal auditor has not yet reviewed the CLO's operations in some important areas, such as its processes for inventorying the assets of the insurance and title companies (insurers) it manages, preparing budgets, and operating its information systems. Had the department enforced its policy, some of the weaknesses we detected and discuss in Chapters 1 and 2 might have been identified and corrected sooner.

The department's poor oversight of the CLO is also evidenced by its lack of follow-up on the deficiencies identified by previous internal and external audits and by its failure to steer the CLO's efforts to implement suggestions for improvement made in those audit reports. For example, the CLO's internal auditor reported weaknesses in the CLO's contract management practices in 1998, but the department did not ensure that the CLO made effective improvements in this area. In addition, the department failed to provide the internal auditor with copies of management reports prepared by the CLO's external auditors. The internal auditor, therefore, was unable to ensure that the CLO took appropriate corrective action regarding the findings and recommendations in these management reports. Unless the department properly oversees the CLO's activities, it cannot make certain that insurers' estates are adequately protected and conserved.

THE DEPARTMENT'S FLAWED OVERSIGHT WEAKENS ITS ABILITY TO ENSURE THAT THE CLO PROPERLY SAFEGUARDS AND MANAGES ESTATE ASSETS

The CLO does not fall under the direct control of the State. The department has interpreted the Insurance Code (code) as exempting the CLO from budgetary oversight by the Department of Finance, oversight of its expenditures and financial statements by the State Controller's Office, oversight of its contracting and purchasing by the Department of General Services, and oversight of its personnel and hiring practices by the Department of Personnel Administration and the State Personnel Board. Based on this interpretation, the department has developed its own oversight process to monitor the CLO's operations. However, during our review of the CLO's operations, we found significant flaws in the department's oversight. Without an effective means to oversee the CLO's operations, the department cannot ensure that the CLO is safeguarding and properly managing estate assets.

Most of the CLO's operations are outside the State's control structure.

An effective oversight process has three basic components: monitoring, reporting, and accountability. Specifically, an effective oversight process should include periodic reviews of accounting and administrative controls to ensure that control weaknesses are promptly identified (monitoring). Once a weakness is identified, an effective oversight process should ensure that it is documented and reported to high-level managers who are in a position to effect change and make policy decisions (reporting). Finally, an effective oversight process should hold an organization accountable for correcting control weaknesses and formally addressing recommendations made by internal and external auditors (accountability). While the department has developed the basic components of an oversight process, we identified significant flaws in both monitoring and accountability that weaken the effectiveness of its oversight efforts.

The Department Has Developed a Monitoring Process

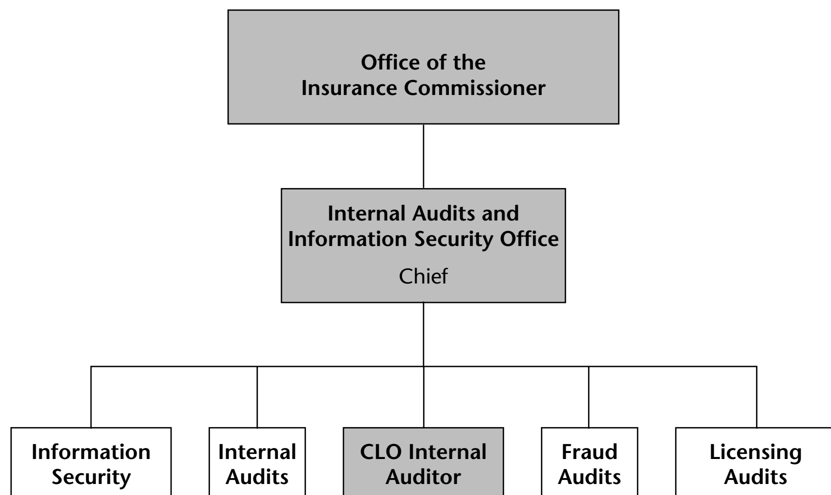
An effective monitoring process is one that provides the department with the independent, objective, and timely information it needs to correct identified weaknesses and make policy decisions. The department has developed a monitoring process that includes annual reviews of the CLO's administrative and accounting controls and ongoing auditing and analysis of the CLO's overall operations. Under the department's guidance, the CLO contracts with an independent auditing firm (external auditors) to conduct annual financial audits of its asset management practices.

Industry standards require the external auditors to review all administrative and accounting controls that are pertinent to planning the extent and timing of the transactions to be tested during the audit. If the auditors note any material weaknesses in the controls they review, they are required to report them to both the department's and the CLO's management. To fulfill requirements set forth in the code, the Department of Finance periodically reviews the reports and supporting documentation prepared by the CLO's external auditors and reports to the insurance commissioner.

The department monitors the ongoing operations of the CLO through its Internal Audits and Information Security Office (audits office). As Figure 3 shows, the CLO's internal auditor is one of five units of the department's audits office. As such, the internal auditor acts as the oversight arm of the department. Although he is a CLO employee, the internal auditor reports directly to the department's chief of the audits office.

FIGURE 3

Organization of the Department's Internal Audits and Information Security Office



Source: Department of Insurance.

The chief of the audits office is responsible for reviewing and approving the CLO internal auditor's audit plan and ensuring that the internal auditor adheres to the department's policies and guidelines, which are closely modeled after professional auditing standards. Under the supervision of the department's chief of the audits office, the internal auditor is responsible for the ongoing auditing and analysis of the CLO's operations and its accounting and administrative controls.

An Overly Long Audit Cycle Has Weakened the Monitoring Process

State law and the department's policies require the internal auditor to conduct a risk assessment every two years based on an analysis of the administrative and accounting controls over all the CLO's operations. The risk assessment identifies the programs and processes that are most vulnerable to control weaknesses and thus require review in the internal auditor's two-year audit plan (we call this two-year period an audit cycle). Following the risk assessment, which was completed in 1997, the CLO's internal auditor developed a two-year audit plan that covered seven major processes: contracts, claims, reinsurance, receivables, certain disbursements, investments, and administration activities that included the inventory process used by the CLO. The CLO's former chief executive officer and chief financial officer approved the audit plan on October 31, 1997. However, the CLO and the department have continually approved revisions to the audit plan, which have extended the audit cycle. Specifically, by October 31, 1999—the end of the most recent two-year audit cycle—the internal auditor had only completed his review of contracts and claims. Within the next year, he completed reviews of reinsurance, receivables, and some disbursements. However, as of June 30, 2001, the internal auditor had not yet completed his review of the investment process or administration activities.

Although a two-year audit plan was approved in October 1997, as of June 30, 2001, the CLO's internal auditor had not yet completed the reviews called for in the plan.

Because of the slippage in completing the reviews called for in the two-year audit plan, a new risk assessment on which to base the audit plan for 2000 and 2001 has not taken place, and the audit cycle, which was to have been completed in October 1999, is ongoing. Therefore, new control weaknesses could now exist in the areas the internal auditor has already reviewed or in other areas that have not been reviewed. For example, the internal auditor has yet to review the CLO's administrative processes for inventorying insurers' assets, budgeting, and the operation of its information systems. As discussed in Chapter 1, we identified significant weaknesses in the CLO's inventory and asset

identification process. Had the department required the internal auditor to adhere to its policy requiring a two-year audit cycle, those weaknesses may have been identified and corrected earlier. Moreover, conducting risk assessments becomes even more important when there have been changes in management. As previously stated, since 1994, the CLO has had four different chief executive officers and undergone numerous other changes in upper management. Therefore, it is important that internal controls are regularly reviewed to ensure that they are in place and working as intended.

Reviewing the CLO's internal controls became even more important because of the frequent changes in management.

Additionally, in 1996, we reported weaknesses in the CLO's personnel policies and procedures. As part of his approved audit plan for disbursements in this area, the internal auditor followed up on the CLO's efforts to implement our recommendations for improvement. However, his testing led him to mistakenly conclude that the CLO had corrected an earlier deficiency we noted in its hiring of employees who did not appear to meet the minimum job requirements for the position. Consequently, as we discussed in Chapter 2, the CLO still has shortcomings in its personnel management practices related to the hiring and promotion of staff.

The Department's Reporting Process Is Adequate

The department has developed an adequate reporting process to ensure that executive management from both the department and the CLO receive reports issued by internal and external auditors. As part of their annual financial audit, the CLO's external auditors issue reports to management, detailing any significant weaknesses they detect in its internal controls and making recommendations for improvement. The external auditors distribute their reports to executive managers in both the department and the CLO. Further, the internal auditor issues audit reports and distributes them to high-level managers in both the department and the CLO.

To Ensure Accountability, the Department Has Policies Requiring Follow-Up on Auditors' Findings and Recommendations

Accountability is one of the most essential components of an effective oversight process. Once problems or control weaknesses have been identified and reported, it is the department's responsibility to hold the CLO accountable for correcting them.

As part of that responsibility, the department must ensure that the CLO addresses recommendations made by internal or external auditors for improving its administrative and accounting controls or operations.

To carry out its responsibilities, the department's policies require the internal auditor to use a three-month, six-month, and one-year response process—including any necessary follow-up reviews of his findings and recommendations—to ensure that the CLO takes corrective action once weaknesses have been identified and reported. Further, department policies and professional standards require the internal auditor to follow up on the findings and recommendations reported by all external auditors to ensure that the CLO takes corrective action.

The Department Has Not Held the CLO Accountable for Correcting Weaknesses in Its Internal Controls

When the internal and external auditors report weaknesses in the CLO's internal controls or operations, the department fails to ensure that corrective action is taken. During his 1998 review of the CLO's contracting policies and procedures, the internal auditor reported weaknesses in the CLO's contract management practices. However, the department did not ensure that the CLO effectively improved its contract management practices in accordance with the internal auditor's findings. We found that the CLO continues to manage its contracts poorly, as we discussed in Chapter 2. Further, in 2000, the internal auditor reported that the CLO did not have comprehensive conflict-of-interest guidelines and policies for its employees. However, the department has not yet required the CLO to finalize and implement a conflict-of-interest policy. As the table on the following page indicates, the department also did not ensure that the CLO corrected several other problems and control weaknesses, despite repeated reporting of these issues by internal and external auditors.

The department has not seen to it that the CLO takes effective corrective action when problems are identified by its internal and external auditors.

TABLE

Repeated Control Weaknesses Reported by Internal and External Auditors*

	Year Reported				
CLO Control Weakness	1996	1997	1998	1999	2000
Contract management	†	NR	‡	NR	NR
Conflict of interest	NR	NR	NR	NR	‡
Closing plans	†	NR	NR	NR	NR
Reinsurance process	NR	§	NR	§	‡ §
Hiring practices	†	NR	NR	NR	‖

Source: Conservation and Liquidation Office (CLO).

* We identified weaknesses in all these areas during our current audit.

† 1996 Bureau of State Audits report.

‡ CLO internal auditor.

§ External auditor management/audit reports.

‖ Reviewed by the CLO internal auditor, but no weaknesses reported.

NR = Not reviewed during this year.

Moreover, the department did not provide the internal auditor with copies of management reports prepared by the CLO's external auditors. Department policies require the internal auditor to follow up on the findings and recommendations reported by external auditors. However, according to the internal auditor, he was not aware that the CLO's external auditors had prepared management reports. Consequently, the internal auditor was unable to ensure that the CLO took the appropriate corrective action regarding the findings and recommendations contained in the external auditor's management reports.

During our audit, the CLO modified its process for responding to the management reports prepared by external auditors. According to its chief financial officer, the CLO will now provide a copy of the management reports, including management's response to the recommendations contained in the reports, to the internal auditor.

RECOMMENDATIONS

To strengthen and improve its oversight process, the department should do the following:

- Ensure that the CLO's accounting and administrative controls are periodically monitored and the highest-risk areas are promptly reviewed by requiring the internal auditor to complete a full audit cycle at least once every two years.
- When the CLO's internal auditor reports on control weaknesses and recommends improvements, make sure that the CLO implements such recommendations or documents why it does not.
- Follow up on the CLO's efforts to implement recommendations for improvement made by external auditors and ensure the status of those efforts is regularly reported.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

ELAINE M. HOWLE
State Auditor

Date: July 31, 2001

Staff: Doug Cordiner, Audit Principal
Debra L. Maus, CPA
Nuno Da Luz
Ana Mason
Gayatri M. Patel
Jessica A. Tucker

Agency's comments provided as text only.

Department of Insurance
Harry W. Low, Insurance Commissioner
300 Capitol Mall, Suite 1700
Sacramento, California 95814

July 19, 2001

Ms. Elaine M. Howle
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

At the time I took office on September 18, 2000 as Insurance Commissioner, I had concerns about the management of the Conservation and Liquidation Office (CLO). For that reason, on October 1, 2000, I began my own internal review of the CLO. Also in October, I sought the counsel of the Attorney General to help me develop a justification that could be used in requesting an audit of the CLO by the State auditor. Subsequently, on November 13, 2000, I provided Senator Jackie Speier the audit justification and requested her to present it to the Joint Legislative Audit Committee in order to have the State Auditor audit CLO. It was my goal to have a credible and independent auditor aid me in identifying and establishing a critical baseline and determining the scope and depth of any weaknesses within the organization.

I reviewed your draft audit report of the CLO entitled "Department of Insurance's Conservation and Liquidation Office: Stronger Oversight is Needed to Properly Safeguard Insurance Companies' Assets." Overall, I concur with the findings presented in the report. The report validated my concerns and provides me with the baseline I need to make certain the CLO's operations are consistent with policies and procedures and in the best interest of the estates it manages.

The results of the audit will allow me to focus my efforts on improving the management of the CLO and to ensure that assets of the entities conserved are safeguarded and efficiently utilized. I have already assembled a team to address the findings of the report. I am happy to note that the CLO was addressing some of the issues identified by your audit prior to its commencement. For example, the CLO was in the process of updating estate plans prior to the start of your audit. Additionally, the CLO had developed an investment advisory committee to begin the process of reviewing its investment strategy. CLO had also assembled a steering committee to assess CLO's claims processing system needs. The goal was to determine whether or not the CLO should retain Lamda or migrate to a different claim processing system. Lastly, I would like to note the reporting

relationship of the CLO internal auditor had been changed to strengthen the oversight of the CLO. Specifically, the CLO internal auditor began reporting directly to the Internal Audit Chief of the Department. I am confident the information you provided me will be significant in my efforts to establish greater effectiveness of the CLO while safeguarding estate assets.

I appreciate the thorough efforts of the Bureau of State Audits and look forward to our continued collaboration as we submit our corrective action plans for your review as part of our 60-day response.

Sincerely,

(Signed by: Harry W. Low)

Harry W. Low
Insurance Commissioner

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press