REPORT BY THE STATE AUDITOR

OF CALIFORNIA

THE DEPARTMENT OF INSURANCE CANNOT COMPLETELY IDENTIFY ITS COSTS FOR IMPLEMENTING PROPOSITION 103 AND PERFORMING EXAMINATIONS

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California State Auditor
Bureau of State Audits

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The fees that the Department of Insurance (department) collects from insurance companies and brokers doing business in the State fund the operating activities of the department. The Insurance Code generally anticipates that the fees the department collects will approximate the costs that the department incurs to regulate the insurance industry and that the fees established to cover the costs of specific regulatory activities will approximate the amount of those related costs. The purpose of this audit was to determine whether the fees that the department levies under Section 12979 of the Insurance Code are based on the actual costs to the department for enforcing Proposition 103, a voters' initiative that passed in November 1988. In addition, the audit was to determine whether the department's charges for the examinations of insurers authorized under Section 736 of the Insurance Code are based on the actual costs to the department for conducting these examinations. Finally, the audit was to report on the actual costs for Proposition 103 and examination activities and to report on whether the costs exceed the revenues from the fees or whether the revenues exceed the costs. Our audit examined this information for fiscal year 1992-93.

During our review, we found the following conditions:

- Although it can separately identify revenues from fees collected to cover the costs of implementing Proposition 103, the department cannot separately identify those costs. The department did not design its accounting system to distinguish the expenditures for Proposition 103 from the costs for performing other regulatory activities. In addition to this problem with the department's design of its accounting system, the department could not provide a reliable alternative methodology for identifying Proposition 103 costs. The department was not able to provide documentation to support many of the costs it stated were incurred for Proposition 103 activities.

- The department had similar problems documenting costs for its examinations of insurance companies. Although the department separately identifies some of its costs for examinations, it does not have a comprehensive method for identifying all costs.

- Because it cannot identify all costs for Proposition 103 or examinations, the department does not have an effective way of determining whether Proposition 103 fees or examination fees should be increased or decreased to match the costs. As a result, the department may be overcharging or undercharging insurance companies for Proposition 103 and for examinations.

- The department does not always use the most appropriate basis for allocating indirect, or overhead, costs to Proposition 103 or examinations. For example, the department allocated indirect costs on the basis of budgeted employee positions, rather than on actual cost data. In addition, the department treated certain expenditures as indirect costs when they should have been charged directly to particular programs, including Proposition 103.

- The department has collected more in revenues for operations than it has needed to cover operating costs. It has had sufficient resources not only to pay for the costs of the department's regulatory activities, but also to lend over $20 million to other funds in one fiscal year. Most, but not all, of these loans have been repaid. In addition, the department has replaced the State's General Fund as the source of funding for the Health Insurance Counseling and Advocacy Program as required by the State's budget acts. In fiscal year 1992-93 alone, the department's funding for this program was $2.9 million. Further, the department transferred $10 million to the State's General Fund, as the budget act for fiscal year 1992-93 required.

- For fiscal year 1993-94, the department is revising its accounting system to identify expenditures related to specific fees. However, to meet its objective, the department must develop an effective way to document resources spent on each type of activity.

Agency Comments

The Department of Insurance generally agrees with the information and conclusions in our report, and it has indicated that it has already begun implementing changes to its accounting system to correct the problems we reported with its cost allocation, cost accounting, billing, and measurement of workload processes. The department plans to have a legal review of the appropriate source of funding for the Health Insurance Counseling and Advisory Program.

Introduction

The primary responsibility of the Department of Insurance (department) is to protect insurance policyholders in the State of California. To meet this responsibility, the department administers programs to protect policyholders, beneficiaries, and the public from the insolvency of insurers and to prevent unlawful or unfair practices by insurers. The department also protects the general public and policyholders from discriminatory, unlawful, or fraudulent practices and incompetence relating to the sale of insurance. The department's activities include conducting examinations of insurance companies and brokers to ensure that their operations comply with the requirements of the Insurance Code. In addition, Proposition 103, a voters' initiative passed in the elections of November 1988, has required the department to develop regulations and implement rollbacks of property and casualty insurance rates. The proposition also requires the department to review and approve changes in property and casualty insurance rates before they go into effect.

The department's regulatory activities are funded almost exclusively from fees assessed against the entities the department is regulating, the insurers and brokers operating in the State. The department assesses various types of fees, which it calculates in different ways, including the following:

- fees established in the Insurance Code for the licensing and certification of insurance companies or brokers, with the amount of the fee varying, depending on the type of license or certification issued;

- direct charges to cover the hourly and travel costs of staff engaged in financial analysis, field, and other examinations that the department conducts on insurance companies;

- fees for closed consumer complaint examinations that vary in amount, depending on the complexity of the issues involved; and

- fees based on the amount of insurance premiums issued to recover the costs the department incurs to meet its regulatory obligations under Proposition 103.

During fiscal year 1992-93, the department received no funding from the State's General Fund. The table on page 3 provides a summary of the department's operating expenditures and receipts for the fiscal year ended June 30, 1993, based on the department's accounting records. During fiscal year 1992-93, the department had additional receipts and expenditures relating to prior fiscal years that are not included in the table. For example, the department's total expenditures were $86 million, including approximately $12 million attributable to prior years.[1] During the last five fiscal years, the department's operating expenditures have increased significantly, from $35.9 million during fiscal year 1988-89 to $86 million.

The commissioner is currently the defendant in lawsuits related to the subject of this report. For example, National Fire Insurance Company of Hartford, et al., v. John Garamendi questions the constitutionality of the fees for Proposition 103 activities. Alternatively, should the fees be found constitutional, the lawsuit charges that the fees are invalid because they are not the type of fee required by Proposition 103 or because they have been improperly put in place. National Association of Independent Insurers, et al., v. John Garamendi similarly challenges the commissioner's authority to charge for the investigation of consumers' complaints against insurance companies and claims that the fees have not been established through the required regulatory procedures.

[1] The table does not include amounts that were received and expended during fiscal year 1992-93 but were related to prior year activity because the department could not provide the detailed information that we needed for the table. The detail was not available for prior years because the department's application and reversal of accruals for those years was done as a single amount that applied to all operating expenditures, not to detailed categories of expenditures.

Department of Insurance Operating Receipts and Expenditures for Fiscal Year 1992-93, As of June 30, 1993

Receipts:	
Insurance company license fees and penalties	$20,587,736
Statistical analysis	8,543
Field rating and underwriting examinations	2,039,270
Conservation and liquidation examinations	755,345
Market conduct examinations	919,037
Field examinations	5,938,439
Actuary examinations	275,122
Financial analysis examinations	1,402,626
Consumer complaint examinations	3,636,053
Proposition 103 fees	23,379,562
Auto fraud assessments	5,805,837
Property fraud assessments	1,318,915
Worker's compensation fraud assessments	3,498,748
Income from surplus money investments	829,230
All other receipts	5,206,851
Total	**$75,601,314**

Expenditures:	
Salaries, wages, and benefits	$43,258,324
General expense	1,572,972
Communications	2,559,201
Travel	1,817,342
Facilities operations	5,901,903
Interdepartmental	4,937,797
Departmental services	3,974,419
Consolidated data center	2,102,329
Central administration	2,648,234
Equipment	2,328,203
All other expenditures	3,094,396
Total	**$74,195,120**

Scope and Methodology

The purpose of this audit was to determine if the fees that the department levies under Section 12979 of the Insurance Code are based on the actual costs to the department for enforcing Proposition 103. In addition, the audit was conducted to determine if the daily rates the department charges for the examination of insurers and any other rate, charge, or fee levied under Section 736 of the Insurance Code are based on the actual costs to the department for conducting these examinations. Finally, the audit was conducted to report on the actual costs for each of these activities and report on whether the costs exceeded the revenues from the fees or whether the revenues exceeded the costs. The Appendix lists the major fees referred to in the legislation mandating this audit, describes the types of activities each fee funds, and describes how the department calculates invoices for each fee.

In conducting this audit, we reviewed laws, regulations, and departmental policies relating to Proposition 103 and to the fees authorized under Section 736 of the Insurance Code. We interviewed personnel in the department's Fiscal Services Bureau, Technology Division, Consumer Services Division, Financial Surveillance Branch, Rate Regulation Division, Legal Division, Press and Publications Office, Public Advisor's Office, and Administrative Law Bureau.

To determine the nature and completeness of the information from the department's accounting records, we reviewed the following for fiscal years 1991-92 and 1992-93:

- selected invoices, receipts, and related documentation;

- recording of fees for Proposition 103 activities and fees for each of the types of examinations of insurance companies conducted and authorized under Section 730, et seq., of the Insurance Code; and

- selected charges for personal services and operating expenditures and the recording of these expenditures in the department's accounts.

Further, we evaluated the department's method for allocating indirect costs by obtaining the list of all program cost accounts used in the department's accounting system in fiscal year 1992-93. Through interviews with department staff and reviews of accounting reports, we determined which accounts accumulated expenditures directly related to Proposition 103 and to the examination of insurance companies and which accounts accumulated indirect costs that were later allocated to the direct accounts. Using this information, we assessed the adequacy of the department's accounting and cost allocation system and determined whether information necessary for our audit was available.

Because the department did not record costs for each regulatory activity and because of other reasons described in Chapter 1 of this report, we cannot provide a documented, detailed analysis of the revenues and expenditures related to each of the activities. We cannot determine with precision how closely revenues matched related expenditures for each of the activities. Instead, we compared the revenues and expenditures for the fund as a whole for fiscal years 1988-89 through 1992-93. We also summarized and analyzed financial data reported in the department's financial reports and the State's annual financial reports issued by the State Controller's Office.

In addition, because the department's accounting system does not disclose which expenditures are related to Proposition 103 activities and which are related to examination activities, we requested from the department a detailed description of these expenditures for fiscal years 1991-92 and 1992-93. We also asked the department to explain the bases for the department's assertion that these expenditures were legitimately related to the fees. Specifically, we asked the department to identify the departmental units that were funded, either in whole or in part, from each of the fees; the percentage of each unit's funding that was from each of the fees; and the nature of the documentation the department could provide to substantiate its responses to our request. We also requested written statements from administrators to confirm our understanding of information we obtained during interviews with them.

Using this information, we compiled expenditure data associated with the fees and compared expenditures to the related revenues reported in the accounting records. The department's information included actual expenditures and encumbrances, which are amounts committed for goods or services to be received after the end of the fiscal year. Throughout the report, when we refer to expenditures, the amounts include both expenditures and encumbrances. We selected detailed data on Proposition 103 fees and on one of the fees, field examination fees, authorized under Section 736 of the Insurance Code for our analysis. To assess the accuracy and validity of the department's information, we interviewed department staff in each of the units that the department told us incurred direct costs related to Proposition 103 and field examinations. We also determined the nature of the supporting documentation for the assertions about costs incurred, and, where possible, tested the validity of the supporting documentation. We noted the reasons for the potentially significant inaccuracies in these data.

In addition to using interview information, we examined significant expenditures that the department included in indirect, or overhead, costs that were allocated to Proposition 103 and the field examinations. We assessed whether these costs should have been included in Proposition 103 and field examination costs.

Finally, we interviewed staff members in the Fiscal Services Bureau who have begun revising the department's accounting system to allow the capture of expenditures for specific fee-related activities. We also reviewed documents describing the nature and purpose of these revisions.

Chapter 1 The Fees the Department Assesses for Proposition 103 Are Not Based on Actual Costs

Chapter Summary

The Insurance Code limits the amount of fees the Department of Insurance (department) should charge to insurance companies under Proposition 103 to the approximate cost the department incurs for its regulatory activities mandated by the proposition. However, the department is unable to separately identify its expenditures related to Proposition 103. Neither its accounting system nor an alternative method for linking costs with the revenues from fees reliably identifies these costs. Because it cannot accurately identify the costs, the department cannot determine whether Proposition 103 fees should be increased or decreased to match the costs of regulatory activities. The department's inability to identify whether Proposition 103 fees should be increased or decreased could result in inaccurate charges to individual companies.

Background

The passage of Proposition 103 in the November 1988 elections resulted in significant new responsibilities, growth, and costs for the department. The department established several new organizational units and incurred additional costs in established units to meet these new responsibilities, which include monitoring and reviewing rates that automobile and property and casualty insurance companies charge in California. The department also anticipated assuming the responsibility for conducting rate application hearings and enforcement proceedings.

In establishing fees to reimburse the department for its costs of implementing Proposition 103, the Insurance Code associates the amount of allowable fees with the costs of performing the regulatory activities. Specifically, Section 12979 states that the Insurance Commissioner (commissioner) shall establish a schedule of filing fees to be paid by insurers to cover any administrative or operational costs arising from the provisions of the code relating to Proposition 103. The commissioner has established this schedule in the California Code of Regulations. Revenues from Proposition 103 fees for fiscal year 1992-93 totaled almost $23 million. The department used the fee schedule in the California Code of Regulations to assess Proposition 103 fees based on the amount of applicable premiums written by an insurance company during the preceding calendar year.

Chapter 1247 of the Statutes of 1993 directed us to determine whether the fees the department assesses for Proposition 103 actually approximate the department's related costs. Specifically, we were required to determine if the fees that the department levies under Section 12979 of the Insurance Code are based on the actual costs to the department for enforcing Proposition 103. In addition, the audit was to report on the actual costs for Proposition 103 regulatory activities and report on whether the costs exceed the revenues from the fees or whether the revenues exceed the costs.

To be able to meet its obligations under the Insurance Code, the department needs an accounting system that correlates the total expenditures of a particular regulatory activity with the total fees collected to support that activity. To be able to assess the appropriate amount of fees, the department must know what its total costs are for that regulatory activity. However, the department did not design its accounting system to track costs in this way.

The Department's Accounting System Does Not Link Costs to Fees

To accurately identify costs by regulatory activity and to link the costs to fees collected for specific regulatory activities, the department needs a more effective accounting system. A well-designed accounting system uses accounts, called "cost centers," to summarize costs at the level and in the format needed to help managers of an organization make decisions and control costs. Cost centers can be established in a variety of ways, depending on the needs of the organization. For example, a management team may need cost information summarized by organizational units or by a product.

The department's managers need cost information summarized as it relates to the fees that the department charges for particular regulatory activities. This information would allow management to make appropriate decisions about the amount of fees to charge. As a hypothetical example, if the department collected $20 million from its Proposition 103 fees, but incurred $23 million in costs to meet its obligations under Proposition 103, the department would have to increase the fees it collects by $3 million to ensure that all necessary costs were covered.

The department's accounting system does not provide the department with the information necessary to make important decisions about how much to charge insurance companies to cover the costs of Proposition 103 activities. Specifically, the department based its cost centers on types of costs, such as salaries and wages, benefits, rent, and telephone costs, or on organizational units, rather than on the nature of the activity performed. The system could capture unit costs in total and by type, but it does not identify costs of activities as they relate to the fees assessed to reimburse the costs.

The department's approach to identifying costs would work only if each organizational unit performed an activity that related to one specific fee. However, some units perform a variety of activities. For example, the Underwriting Services Bureau, which had $5.5 million in expenditures during fiscal year 1992-93, conducted work for both Proposition 103 activities and for consumer complaint activities, which are funded by two separate fees. Although the department provided us with an estimate of the costs associated with each of the two activities, the accounting system itself made no such distinction. Similar conditions existed for several other organizational units, including the Rating Services Bureau, which had $1.7 million in expenditures that the department told us was split between Proposition 103 and consumer complaint activities. In each case, the accounting system made no distinction between the amount of expenditures for each kind of activity. As a result, the accounting system failed to provide the department with critical information for determining whether the fees collected for each activity approximated the department's costs for each activity.

The Department's Alternative Methodology for Linking Costs to Fees Collected Is Unreliable

Adding to the department's failure to establish an accounting system to link costs with fees collected is the department's lack of any documented alternative system to link them. We asked the department to provide us with an alternative methodology it considered reliable for linking costs for Proposition 103 to fees collected. The information in the alternative methodology that the department provided identifies the departmental units that were funded, either in whole or in part, from Proposition 103 fees; the percentage of each unit's funding that was from each of the fees; and the nature of the documentation the department could provide to substantiate its responses to our request. When we used the department's methodology to calculate the costs related to Proposition 103 and then compared the total expenditures to revenues from Proposition 103 fees, we found that the revenues and expenditures were almost equal during fiscal year 1992-93. However, we question the reliability of these data for several reasons. The department could not provide documentation to support the validity of much of the information in the methodology. In addition, at different times, the department provided different descriptions of how to determine costs related to Proposition 103. Finally, the department included some costs that we do not believe were legitimate Proposition 103 costs.

The Department Cannot Document the Reliability of Its Alternative Methodology

The department often could not provide documentation supporting its assertions in its methodology that either all or some of the expenditures of certain organizational units were related to Proposition 103 activities. In many instances, the department based its assertions on proposals for changes to the department's budgeted expenditures. Although such documents provide information about the anticipated purposes for requested resources and additional staff, they do not document the actual use of the resources or staff. To assess the reliability of the department's assertions and their applicability to the 1992-93 fiscal year, we interviewed key personnel in 14 of these units. None of the units that engaged in more than one regulatory activity required activity-based reporting of staff time. An activity-based time reporting system for the department would require staff members to record the amount of time they spend in each type of regulatory activity. In addition, only one unit had completed an analysis that documented expenditures incurred for Proposition 103 regulatory activities.

Because at least six units were created in response to Proposition 103, it is reasonable to assume that most of these units' expenditures, totaling approximately $11 million in fiscal year 1992-93, relate to Proposition 103. However, other units, such as certain consumer services units, existed before passage of the proposition and appear to be incurring some Proposition 103 costs. These units also apparently have significant responsibilities unrelated to Proposition 103 and do not document which of their expenditures relate to Proposition 103 activities and which expenditures relate to other activities.

The Department's Alternative Methodology Differs From Other Methods It Has Prepared To Identify Proposition 103 Costs

Different descriptions from the department about how to calculate Proposition 103 costs also bring into question the reliability of the data that the department provided to us. During this audit, we obtained the following four methods, which the department prepared at different times and for different purposes, for identifying Proposition 103 costs

- One method consists of a set of assertions from questionnaires and interviews with unit administrators that were completed in July and

August 1993. The department has used the results of these interviews and questionnaires to help revise the department's accounting system for fiscal year 1993-94;

- Another method consists of a set of assertions we obtained during the audit when we interviewed the same administrators to determine if they still considered their initial assertions reliable. We conducted our interviews between December 1993 and March 1994. The department has not used this information in any practical application;

- A third method, from the department's written representation to us dated February 7, 1994, was prepared in response to our request. This is the methodology we have discussed above. Again, the department has not used this information in any practical application; and

- The last method consists of an additional description from the department about how it calculated Proposition 103 costs. The department included this description in its transmittal letter accompanying the department's billings for Proposition 103 fees to insurance companies for fiscal year 1992-93.

Significant differences exist among the methods. Data from the first method identify 12 units with direct costs and the percentage of unit costs associated with Proposition 103. None of the other three methods uses exactly the same data. Following are examples of the differences.

- Data from our interviews with the same administrators differ from the information used for the accounting system. For example, according to the estimates provided for use in the revision of the accounting system, the percentage of total expenditures for the press and publications unit, which had $343,000 in 1992-93 expenditures, was 75 percent. According to the interviews we conducted, the unit's percentage of costs for Proposition 103 activities was 10 to 20 percent;

- The February 7, 1994, representation asserts that four organizational units that were not identified in the questionnaires used to revise the accounting system also incurred costs for Proposition 103 activities. The department estimates the additional Proposition 103 costs associated with these four units to be $5 million; and

- The department's transmittal letter accompanying the billings to insurance companies contains a general description of how costs for Proposition 103 were determined that conflicts with the data from the three other methods. The estimate of Proposition 103 costs in the transmittal letter was up to 20 percent higher than the estimates from the other methods.

Without thorough documentation supporting any of the four methods, we were unable to conclude which method, if any, is accurate.

The Department Included Questionable Costs in Its Summary of Proposition 103 Costs

We also question other costs the department said it incurred for Proposition 103 activities. Specifically, the department included in its February 1994 representation $1.45 million in costs for the Health Insurance Counseling and Advocacy Program (HICAP), even though the HICAP is concerned with health insurance for elderly Californians. The program is designed to help them understand the federal Medicare health insurance coverage, evaluate what additional coverage they might need, and avoid the purchase of unnecessary or duplicative health insurance coverage. Because Proposition 103 is concerned with property and casualty insurance, not health insurance, we question the relevance of the HICAP to Proposition 103.

The department's chief fiscal officer informed us that the budget act for 1992-93, Chapter 587 of the Statutes of 1992, requires that costs for the HICAP be charged against the department's support appropriation, which includes the Proposition 103 costs, and therefore Proposition 103 should be charged for part of the HICAP costs. Although we recognize the requirements of the budget act, we nevertheless find no benefit to Proposition 103 activities from the HICAP and see no justification for spending fees collected to fund regulatory activities for Proposition 103 to support a program for disseminating health insurance information to the elderly. In addition, in determining which programs to charge with the HICAP costs, the department asserted that it excluded the tax collection, earthquake, and fraud programs funded by the department's support appropriation because of specific statutory restrictions on these revenues. Based on the statutory provision that Proposition 103 fees should be used to cover the costs of implementing Proposition 103, we believe that the department should also exclude the Proposition 103 program.

The Department May Be Inaccurately Calculating Proposition 103 Fees

Because it cannot identify Proposition 103 costs as they relate to fees collected, the department has no basis for determining whether the fees it assesses for Proposition 103 are accurate. As a result, the department cannot demonstrate that it has met its obligation under the Insurance Code of assessing fees to cover administrative and operational costs.

Nevertheless, in its transmittal letter accompanying the billings to insurance companies for fiscal year 1992-93, the department stated that it would adjust Proposition 103 fees for fiscal year 1993-94 for any excess fees collected in fiscal year 1992-93. When we interviewed the staff responsible for the accounting and rate-setting activities for Proposition 103, we found that the department could not provide any evidence that it had compared expenditures with revenues to determine whether any excess revenues were collected. Furthermore, the department did not adjust the fees. Indeed, without an accurate way of identifying whether the fees exceeded the costs, the department could not have justified any adjustment it might have made.

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Chapter 2 The Department Does Not Separately Identify All Expenditures Incurred for Conducting Examinations

Chapter Summary

According to the Insurance Code, the fees the Department of Insurance (department) assesses for several types of examinations it conducts should approximate the amount of related costs the department incurs in performing these examinations of insurance companies. However, the department does not have a system to separately identify all the expenditures related to the fees collected. Although the department documents the number of hours staff members directly spend on examinations, it cannot adequately support the basis for some of the related costs. As a result, the department is unable to determine effectively whether fees charged to insurance companies for regulatory examinations should be increased or decreased to match the costs of regulatory activities. The department's inability to identify whether specific fees should be increased or decreased could result in overcharging or undercharging individual companies. Indeed, by its own estimates, the department often overcharges or undercharges.

Background

The department conducts several kinds of regulatory examinations of insurance companies, such as market conduct, financial analysis, field, and various other examinations. The Insurance Code indicates that the fees the department assesses for these examinations should approximate the amount of related costs the department incurs in conducting these examinations. Specifically, Section 736 of the Insurance Code directs that all examinations shall be at the expense of the insurer, organization, or person examined, except that special examinations that are in addition to regular examinations may be at the expense of the State at the discretion of the Insurance Commissioner. In general, the department reimburses its costs for these examinations by directly charging the insurance companies it examines to cover the hourly and travel costs of staff members engaged in the examination. The Appendix lists the categories of fees, describes the types of examinations each fee funds, and describes how the department calculates invoices for each fee.

Chapter 1247 of the Statutes of 1993 directed us to determine whether the fees the department assesses for conducting examinations actually approximate the department's related costs. Specifically, we were required to determine if the fees that the department levies under Section 736 of the Insurance Code are based on the actual costs to the department for conducting the examinations. In addition, the audit was to report on the actual costs for examination activities and report on whether the costs exceed the revenues from the fees or whether the revenues exceed the costs.

We selected the examination with the most revenues, field examinations, for review in greater detail. Field examinations, a long-standing department activity, are periodic on-site examinations of insurers to determine their financial condition and ensure that they are complying with laws and regulations. Total revenues for field examinations for fiscal year 1992-93 were almost $6 million. The department assessed the field examination fees based on the number of staff hours needed to complete each examination and on standard hourly rates. The department also billed for travel costs incurred during the examinations.

Although the Department Documents Staff Time for Which It Directly Bills, It Cannot Document All Costs for Examinations

As we discussed in Chapter 1, the department does not have an accounting system that links all expenditures incurred for examinations to the fees assessed for each examination. We asked the department to provide us with alternative methodologies it considered reliable for linking costs of specific examinations to fees assessed. In evaluating the reliability of the department's information about these expenditures, we found that some of the department's assertions in its methodologies lacked supporting documentation or were of questionable reliability. We then selected field examinations, the type of examination with the most revenues in fiscal year 1992-93, for a detailed review. We found that when the department allocated costs of the actuarial unit to field examinations, it included $708,000 more than it should have. Because it cannot document all costs for examinations, the department has no effective way to determine whether examination fees should be increased or decreased to match the costs incurred.

The examination units that directly bill insurance companies for reimbursement of costs based on staff time require their staff members to maintain detailed time sheets that document the amount of time they spend on each examination. These units include staff members who conduct field rating and underwriting examinations, conservation and liquidation examinations, market conduct examinations, field examinations, actuarial services, and financial analysis examinations. We reviewed selected time sheets for these staff members and determined that the hours for which the department billed insurance companies agreed with the data on the certified time sheets.

However, the hourly billing rates that the department charged for examinations in fiscal year 1992-93 were not based on the actual costs of these examinations. During fiscal year 1990-91, the department used data effective January 1, 1991, to calculate the billing rates of $66 per hour for nonsupervisorial staff and $87 per hour for supervisorial staff. The department has not subsequently updated this calculation. In addition, the department calculated the rates by averaging the costs of five different units performing examinations for which the department directly billed. These units were the conservation and liquidation unit, the field rating and underwriting unit, the financial analysis unit, the claims services unit, and the field examination unit.

Each unit has used the same billing rates, even though the department's calculation of billing rates for individual units disclosed wide variances from the average. For example, the department's calculated rates for supervisorial services ranges from a low of $54 for field examinations to a high of $164 for financial analysis examinations. Therefore, an insurance company examined by the field examination unit would be billed $33 ($87 less $54) more per hour of supervisorial time than the department calculated as the appropriate rate for field examinations. On the other hand, a company that underwent a financial analysis examination would be billed $77 ($164 less $87) less per hour than the calculated rate. Without a more current, specific calculation of the rates for examinations, the department cannot demonstrate that the charges to insurance companies under examination in fiscal year 1992-93 approximated actual costs.

In addition, we question the reliability and completeness of some of the other information provided to us by the department to identify the costs of field examinations. For example, the department asserted in the alternative methodology that it provided at our request that 50 percent, or $885,000, of the total expenditures of the actuarial unit related to field examinations. However, in an interview with us, the unit administrator stated that only 10 percent of the unit's costs, totaling $177,000, related to field examinations. The administrator based his statement on the results of a time-reporting system maintained in the actuarial unit for the first half of the 1992-93 fiscal year. We determined that the data from the unit's time-reporting system were reliable by reviewing the system's summary of time spent on field examinations and the supporting documentation that the unit administrator provided to us. Based on our interview with the administrator and our review of the actuarial time-reporting system, we conclude that, in its representation to us, the department overstated actuarial costs related to field examinations for fiscal year 1992-93 by approximately $708,000.

The Department's Estimates Suggest That Overcharging or Undercharging Is Common

The department's inability to identify whether specific fees should be increased or decreased could result in overcharging or undercharging of individual companies. The department's own estimates of costs suggest that material overcharging or undercharging is common. Using the alternative methodologies for identifying the costs for examinations that the department provided to us, we calculated the expenditures, which we then compared to related revenues. Our analysis of the department's data disclosed that fees assessed to insurance companies reimbursed 91 percent of the expenditures for field examinations, 59 percent of expenditures for financial analysis examinations, 115 percent of expenditures for field rating and underwriting examinations, 57 percent of expenditures for market conduct examinations, 49 percent of expenditures for conservation and liquidation examinations, and 59 percent of expenditures for consumer complaint examinations. These estimates suggest that the department is generally undercharging insurance companies for these regulatory examinations or is not devoting sufficient staff time, which is the basis for billings, to the examinations. However, we cannot attest to the accuracy of these estimates because many of the department's assumptions used in developing its methodologies were not based on documented data.

Chapter 3 The Department's Allocation of Overhead Costs Is Not Always the Most Appropriate or Consistent

Chapter Summary

Problems and inconsistencies existed with the Department of Insurance's (department) accounting treatment of various indirect, or overhead, costs that raise questions about the appropriateness of the allocation system. For example, the department allocated indirect costs to organizational units based on budget data for employee positions, rather than on actual cost data. Additionally, the department treated certain expenditures as indirect costs and allocated the costs to the various organizational units, when they more appropriately represented direct costs of particular programs. Finally, the department's estimate of the portion of its costs related to Proposition 103 for a particular unit was inconsistent with the treatment of these costs in the accounting system.

The Allocation of Overhead Costs to Proposition 103 and Field Examinations Is Not Always the Most Appropriate or Consistent

Indirect costs generally are those costs that cannot be easily identified with or assigned to a given cost center. During fiscal year 1992-93, examples of the department's indirect costs included the expenditures for office and photocopying supplies, library purchases, postage, security, and similar purchases. The expenditures associated with Proposition 103 and field examinations consist of direct and indirect costs, with indirect costs a substantial portion of the total. The department's accounting system accumulated these indirect costs in indirect cost centers and ultimately allocated them to direct cost centers, including those related to Proposition 103 and field examinations.

The cost allocation system that the department used during fiscal year 1992-93 was not always the most appropriate or reliable, a condition that could have a substantial impact on the amount of indirect costs attributable to Proposition 103 and field examination activities. Specifically, the accounting system allocated indirect costs to organizational units on the basis of budgeted employee positions. A simple example illustrates the process. If a unit had 100 budgeted positions and the department had 1,000 total budgeted positions and total indirect costs of $2 million, the unit would be allocated 10 percent of indirect costs, or $200,000. However, allocating costs based on budgeted positions, rather than on positions actually filled, may result in an inequitable distribution of costs because it is not based on actual conditions. A program may have a budget for more positions than the department has been able to fill, but the program would be allocated indirect costs as if all the positions were filled. If the unit in the example above had filled only 80 of its 100 budgeted positions under an allocation system based on budgeted positions, the unit would still be allocated $200,000 in indirect costs. Under an allocation system based on actual positions, the unit would be allocated only $160,000. Allocating indirect costs on a more equitable basis would result in more accurate and meaningful cost information for the cost centers, helping the department to identify more precisely the costs associated with particular regulatory activities, such as Proposition 103 activities or field examinations. We did not determine the effect of the differences between the two allocation bases on Proposition 103 or field examination costs.

Further, some costs associated with the Technology Division, which provides data processing and telecommunications services for the department, were directly chargeable to units associated with Proposition 103 activities. However, the department indirectly allocated the division's costs, which totaled $7.7 million in fiscal year 1992-93, to other organizational units as well as to Proposition 103 units. According to the division's administrator, a portion of the resources of this division was devoted directly to Proposition 103 activities, and the functions of this division were expanded as a result of Proposition 103. Specifically, the passage of the proposition resulted in the division's hiring 14 additional staff members and purchasing new computer systems. The administrator could not quantify the costs of the unit that were devoted to Proposition 103 activities. By not directly charging these costs to the appropriate organizational units within the department that work on Proposition 103 activities, the department understated costs for Proposition 103 and overstated costs to units engaged in other activities, such as the field examinations.

We also question the reliability of the department's allocation of indirect costs because the department's statements are inconsistent with its own practices. Specifically, the department's written statements to us about the costs of the statistical analysis unit conflicted with the treatment of these costs in the department's indirect cost allocation process. In its February 1994 representation to us, which we discuss in detail in Chapter 1, the department asserted that 85 percent of the costs of the statistical analysis unit were related to Proposition 103 activities and 15 percent of the costs were related to statistical analysis examinations during fiscal year 1992-93. However, according to another description of its cost allocation system the department provided to us, the department's accounting system treated the costs of the statistical analysis unit as indirect costs that it distributed to other cost centers. The department subsequently provided us with a still different description of the allocation system that indicated that the accounting system distributed 96 percent of the unit's costs to Proposition 103 and 4 percent to activities of the earthquake recovery program.

Because the department could not provide reliable documentation demonstrating the propriety of any of these allocations, we were unable to determine which, if any, is correct.

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Chapter 4 The Department Has Collected More Revenues Than It Has Needed To Cover Its Operating Costs

Chapter Summary

The Department of Insurance (department) has collected more in revenues for operations than it has disbursed. From June 30, 1987, to June 30, 1992, the balance in the department's operating fund increased from $7.5 million to over $25 million, an increase of $17.5 million. The department has had sufficient resources not only to pay for the costs of the department's regulatory activities, but also to lend over $20 million to other funds in one fiscal year. In addition, the department has replaced the State's General Fund as the source of funding for the Health Insurance Counseling and Advocacy Program (HICAP). In fiscal year 1992-93 alone, the department's funding for this program was $2.9 million. Further, the department transferred $10 million to the State's General Fund, as the budget act for fiscal year 1992-93 required.

Revenues Have Significantly Exceeded Disbursements for the Department's Operating Fund as a Whole

Although neither we nor the department can validate the costs associated with any specific fee-related activity, revenues clearly exceeded disbursements for the department's operating fund as a whole, as indicated by increases in the fund balance and by other financial activity in the department's operating fund. The fund balance generally indicates whether the fund has had more revenues or more disbursements during the existence of the fund. A fund balance of zero indicates the revenues and disbursements have been equal, whereas a positive fund balance means that revenues have exceeded disbursements and a negative fund balance indicates that disbursements have exceeded revenues. We gathered our financial data from the State's annual financial statements issued by the State Controller's Office for fiscal years 1986-87 through 1991-92, the most recent of such reports, and from the financial reports the department submitted to the State Controller's Office for fiscal years 1988-89 through 1992-93.

Revenues clearly exceeded disbursements for the operating fund as a whole both before and after June 30, 1987. The annual financial reports for the State indicate that the fund balance in the department's operating fund was $7.5 million at June 30, 1987, and had increased to over $25 million by June 30, 1992. The amount that has accumulated in the fund balance is not entirely the result of policies over which the department has control. For example, the department has demonstrated that $13.9 million of the fund balance consists of moneys related to three fraud programs. The amount of fee assessments for two of the fraud programs is established in the Insurance Code. For the automobile fraud program, Section 1872.8 of the Insurance Code requires the department to assess insurance companies $1 annually for each automobile insured. For the general fraud program, Section 1872.7 of the Insurance Code requires the department to assess a $1,000 annual fee against insurance companies doing business in California. For a third fraud program, the Workers' Compensation fraud program, Section 1872.83 of the Insurance Code requires other agencies to assess and collect the revenues and transfer a portion of the revenues to the Department of Insurance. In each case, revenues for each fraud program increased the fund balance in the department's operating fund.

Although it received the revenues intended to support the three fraud programs, the department asserts that budget legislation limited its spending authority for the fraud programs to amounts significantly lower than revenues collected and the department's ability to spend is limited to the amounts budgeted. However, the department was partially responsible for the limitation on its spending authority for fiscal year 1991-92. The department applied to the Department of Finance for a budget augmentation for the fraud program that was rejected because the department failed to adequately justify its request.

Other financial activity in the fund indicates that the department has more resources in its operating fund than it has needed for operating expenditures. This financial activity includes, but is not limited to, the following.

- The department's financial reports submitted to the State Controller's Office indicate that, during fiscal year 1992-93, revenues exceeded expenditures by approximately $4 million. (This differs from the information in the table on page 3, because the table reflects only a portion of the financial activity during fiscal year 1992-93, which we discuss in the footnote on page 2 of this report.) The excess of revenues over expenditures would increase the fund balance as of June 30, 1993;

- The department transferred $10 million from the fund to the State's General Fund in fiscal year 1992-93, reducing the fund balance as of June 30, 1993. Chapter 587 of the Statutes of 1992 required the transfer;

- The operating fund had sufficient cash available to lend $6.7 million to the State's General Fund and $15 million to the California Residential Earthquake Recovery Fund as of June 30, 1992. The loan to the earthquake recovery fund was repaid in fiscal year 1992-93;

- The operating fund had sufficient cash available to lend $8.3 million to the State's General Fund as of June 30, 1993; and

- In fiscal year 1987-88, the department's operating fund began funding the HICAP, a program previously funded through the State's General Fund. The budget acts for fiscal years 1989-90 through 1992-93 required the transfer of a total of $11.2 million from the department's operating fund to the Department of Aging to support this program. For fiscal year 1992-93 alone, the budget act required the transfer of $2.9 million, reducing the fund balance as of June 30, 1993.

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Chapter 5 The Department Has Begun Revising Its Accounting System, But Additional Changes Are Needed

Chapter Summary

The Department of Insurance (department) has begun implementing changes to its accounting system that would permit it to identify expenditures reimbursed by specific fees. Among the changes is the restructuring of the accounting cost centers. The department has established accounts that summarize the costs for Proposition 103 and other discrete regulatory activities. However, costs are accumulated in these accounts based on estimates of the appropriate amount to charge to each activity, rather than on actual data documenting costs. Thus, the structure exists to permit the department to identify the costs for Proposition 103 separately, for example, but the amounts identified as Proposition 103 costs will not be verifiable. In addition, the department has not provided sufficient guidance to its staff for distinguishing which of the staff's activities relate to each regulatory fee.

The Department Has Begun Making Some Necessary Changes to Its Accounting System

During fiscal year 1992-93, the department took preliminary steps to revise its accounting system. For example, in February 1993 it hired a staff person to review its billing rates. For fiscal year 1993-94, the department began actually implementing revisions to its accounting system to better meet its informational and reporting needs. In particular, the department expects these changes to capture expenditures by regulatory activity and to help provide accurate cost information for the purpose of billing insurance companies. Two changes the department has made for fiscal year 1993-94 primarily respond to the needs discussed in this report and are an appropriate initial step for revisions to the system. First, the department has established accounting cost centers based on activity, which should allow the department to distinguish the amount of its costs related to a particular regulatory activity. After the department is able to determine the costs associated with an activity, it will know how much it should collect in fees from those companies that benefit from the activity. Second, the department has indicated that it allocates some of its indirect costs on the basis of actual personnel costs and other indirect costs, such as rent and information technology services, on actual usage.

Although we did not review the department's preliminary revisions in detail, during our audit we noted certain issues that the department will have to address before the revised accounting system will fully capture costs accurately. One such issue deals with the department's need for an effective way to document actual resources spent on each type of regulatory activity. Many units still do not use activity-based time reporting or an alternative method of documenting resources spent on specific activities. The accounting system put in effect during fiscal year 1993-94 uses pre-set percentages to allocate costs of organizational units to cost centers in which the costs of regulatory activities are accumulated. The pre-set percentages are based partially on estimates of time spent on each type of regulatory activity that the department obtained from its administrators. For example, 43 percent of the cost of the Policy Research Bureau is allocated to a cost center for Proposition 103 regulatory activity. This is an effective way for the department to accumulate the costs associated with a particular regulatory activity if the pre-set percentages are accurate. However, our interviews with unit administrators generally disclosed that they did not base their estimates on any documented analysis. Thus, the accounting system will use the pre-set percentages to distribute expenditures to the activity-based accounting cost centers, providing the appearance that the accounting system is recording actual costs associated with these activities. If the pre-set allocation percentages are not based on actual conditions, this appearance would be misleading. The department staff members who are revising the accounting system have recognized the need for activity-based time reporting to document time spent on each activity and have indicated that the development of such a system is in progress.

The lack of consistency in the department's assertions about Proposition 103 costs further emphasizes the need for a well-documented basis for the percentages used in the accounting system during fiscal year 1993-94. As we discussed in Chapter 1, data in the department's alternative methodology for identifying its costs for Proposition 103 differed significantly from the information the department obtained from the unit administrators for the purposes of revising the accounting system.

Another issue that the department should address to ensure that its revisions to the accounting system result in the accurate identification of expenditures is the need for the department to provide general guidance to its staff on properly distinguishing between activities when the potential for overlap exists. Several of the administrators we interviewed stated that they had not been given any guidance on how to make such distinctions.

For example, the underwriting services unit addressed various kinds of consumer complaints, including some related to Proposition 103. In categorizing which of the complaints were related to the proposition and which were not, the unit supervisor used a definition that he stated had been reviewed and approved by executive staff. The definition limited Proposition 103 costs to those costs incurred to deal with specific complaints about providers of automobile insurance. The specific complaints included the cancellation and nonrenewal of insurance, the refusal to insure, and the refusal to send a policy.

In contrast, the administrator of the rating services unit, which deals with other consumer complaints, used a much broader definition of Proposition 103 costs. The administrator indicated that he determined Proposition 103 costs based on the type of insurance in each consumer complaint. Our review of some of the closed consumer complaint files in his unit confirmed that the type of insurance, such as automobile insurance or property and casualty insurance, dictated its classification as a Proposition 103 complaint or another category of complaint. Thus, any complaint about automobile insurance, regardless of the issue, was categorized as a Proposition 103 complaint. This lack of general guidance could have a significant effect on the costs the department charges to each activity.

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Chapter 6 Conclusions and Recommendations

Conclusions

The fees that the Department of Insurance (department) collects from insurance companies and brokers doing business in the State fund the operating activities of the department. The Insurance Code generally anticipates that these fees will approximate the related costs the department incurs to regulate the State's insurance industry. The Insurance Code also anticipates that the fees established to cover the costs of specific regulatory activity will approximate the amount of those related costs. Because it is unable to determine the actual costs it incurs for specific regulatory activities, however, the department has not ensured its compliance with these provisions of the Insurance Code. The department clearly has collected more total revenue than it has needed to cover the expenditures it has incurred for its regulatory activities.

Proposition 103 Fees and Expenditures

The department separately identifies the revenues that it receives from fees collected to cover the costs of implementing Proposition 103. However, it cannot separately identify these costs. The department's accounting records do not distinguish the costs it incurs to implement Proposition 103 from the costs for conducting its other regulatory activities. In addition, an alternative methodology for identifying the costs, which the department prepared at our request, is unreliable. Because it cannot accurately identify the costs of implementing Proposition 103, the department is left without an effective way of determining whether Proposition 103 fees should be increased or decreased to match the costs. As a result, the department may be inaccurately charging insurance companies for Proposition 103.

Examination Fees and Expenditures

The department separately identifies only some of the costs it incurs to conduct its examinations of insurance companies. Specifically, the department bases the fees it charges insurance companies on the number of hours staff members spend on each examination, and the department documents these hours with detailed time sheets that the staff members prepare. However, the hourly rates the department charges for examinations are not based on actual costs. In addition, when we selected the examination fee with the most revenues, field examinations, for a detailed review of the documentation of its costs, we found that the department could not document the basis for some of the costs. For example, the department claimed that 50 percent of the costs of the actuarial unit were devoted to field examinations, but we reviewed summaries of time sheets that indicated that only 10 percent of the unit's time was spent on field examinations. Because it cannot accurately identify all costs for each examination, the department cannot determine whether it should increase or decrease its fees to cover the costs of the examinations. In addition, the department may be overcharging or undercharging for examinations. In fact, the department's own estimates suggest that significant overcharging or undercharging is common.

Indirect Costs

The department's allocation of indirect, or overhead, costs is not always the most appropriate or consistent. Specifically, the department allocated indirect costs based on budget data for employee positions, rather than on actual cost data. Further, the department treated certain expenditures as indirect costs that it allocated to various cost centers, when the costs should have been treated as direct costs of particular programs. Finally, the department estimated that 85 percent of the costs of the statistical analysis unit was directly chargeable to Proposition 103 cost centers and 15 percent was directly chargeable to statistical analysis examinations. However, the department charged different amounts to these programs.

Total Revenues and Expenditures for the Department

The department has collected more revenues than it has needed to cover operating costs. From June 30, 1987, through June 30, 1992, the fund balance in the department's operating fund increased from $7.5 million to over $25 million. At the same time, the department has had sufficient resources not only to pay for the costs of the department's operating activities, but also to lend over $20 million to other funds in one fiscal year. As required by the State's budget acts, the department has also replaced the State's General Fund as the source of funding for the Health Insurance Counseling and Advocacy Program, funding that amounted to $2.9 million for fiscal year 1992-93 alone. Finally, during fiscal year 1992-93, the department transferred $10 million to the State's General Fund, as required by Chapter 587 of the Statutes of 1992.

Changes to the Accounting System for Fiscal Year 1993-94

The department has begun implementing changes to its accounting system that would permit it to identify expenditures that are reimbursed by specific fees. Among the changes is the restructuring of the accounting cost centers. The department has established accounts that summarize the costs for Proposition 103 and other discrete regulatory activities. However, costs are accumulated in these accounts based on estimates of the appropriate amount to charge to each activity, rather than on actual data documenting costs. Thus, the structure exists to permit the department to separately identify the costs for Proposition 103, for example, but the amounts identified as Proposition 103 costs will not be verifiable. In addition, the department has not provided sufficient guidance to its staff members for distinguishing which of the staff members' activities relate to each regulatory fee.

Recommendations

To ensure that it complies with statutory requirements that fees approximate the amount of costs the department incurs to conduct its regulatory activities, the department should periodically compare expenditures and related revenues from fees. When the department's costs significantly exceed the fees collected or when the fees collected significantly exceed the department's costs, the department should adjust fees accordingly.

The department should devote sufficient resources to promptly implement the necessary changes to its accounting system.

- To ensure consistency in its allocation of expenditures to cost centers related to regulatory activities, the department should provide clear guidance to its staff members on distinguishing among activities; and

- To ensure that its revised accounting system satisfies its reporting and informational needs, the department should document the propriety of its allocation of costs to the activity-based cost centers. Such documentation may vary among organizational units and could consist of activity-based time reporting, workload or output analyses, or any other reasonable analysis that uses data spanning enough time or resources to be reliable. For example, with activity-based time reporting, the department would be able to document what portion of its personnel costs were devoted to each of the activities. If an organizational unit incurred total costs of $1 million, and time sheets indicated that 50 percent of staff time was spent on Proposition 103, 40 percent was spent on field examinations, and 10 percent was spent on a special project, the department would charge $500,000 to the Proposition 103 cost center, $400,000 to the field examination cost center, and $100,000 to the special project cost center.

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

Respectfully submitted,

KURT R. SJOBERG
State Auditor

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APPENDIX

Department of Insurance Fees Addressed in Chapter 1247, Statutes of 1993

Name of Fee	Nature of Activity Funded by Fee	Procedures for Calculating Fee
Proposition 103 recoupment fees	Monitor and review rates charged by property and casualty insurance companies; evaluate rate applications; conduct rate application hearings and enforcement proceedings; provide actuarial services; study auto rate comparisons and maintain statistics from rate filings; provide legal representation, including outside consultants, expert witnesses, and intervenor compensation; and provide centralized services from various state agencies.	The Department of Insurance (department) establishes the Proposition 103 recoupment fees by estimating the department's expenditures related to Proposition 103 for the coming fiscal year and then assessing each insurance company a fee. The fee is based on the amount of premiums the insurance company issued for each type of insurance covered by Proposition 103. If a company does not sell policies for any insurance types covered by Proposition 103, then it does not pay a recoupment fee.
Field examinations	Conduct on-site audits of insurers to determine the financial condition of insurers and ensure that they are complying with laws and regulations.	The department recovers the costs of these examinations from the examined company by charging an hourly rate for the examiners' time, plus travel expenses directly attributable to each examination. The daily rate is based on the salary level of the employees performing the examination plus an overhead factor. The department currently uses two hourly rates, one for personnel at or below the level of associate insurance rate analyst and a second for personnel at or above the level of senior insurance rate analyst. However, if specialized personnel are required, such as an actuary or attorney, the department uses hourly rates established for those classifications.
Field rating and underwriting examinations	Conduct on-site audits of insurers to ensure that they are complying with laws and regulations related to underwriting and rating practices.	
Conservation and liquidation activities	Operate insolvent companies to ensure that claims are properly adjusted.	
Market conduct surveys	Conduct on-site audits to review insurers' claim handling practices.	
Actuary examination	Conduct reviews of insurance companies' ability to pay claims. Review requests for rate increases.	
Financial analysis activity	Maintain ongoing surveillance of insurers to identify those in hazardous financial condition and perform financial analysis of insurance companies for various purposes, such as applications for certificates of authority.	
Statistical analysis activity	Provide technical advice relating to rating data collection plans and automation of statistical and rating systems.	
Complaint investigation	Investigate and resolve consumer complaints regarding the handling of claims, underwriting practices, and rates.	Upon completion of the investigation, the department charges a fee to the company against which the complaint was filed. The department charges one of two flat fees: \$198 for complaints with relatively simple issues and \$285 for complaints with more complex issues.