Audit Report

Office of the State Treasurer

July 2014

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

July 15, 2014

Karl S. Aro
Executive Director

Thomas J. Barnickel III, CPA
Legislative Auditor

Delegate Guy J. Guzzone, Co-Chair, Joint Audit Committee
Senator James C. Rosapepe, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Office of the State Treasurer (STO) for the period beginning July 1, 2009 and ending August 29, 2012. STO is responsible for the receipt, disbursement, safekeeping, and investment of the funds of the State Treasury. STO is also responsible for procuring banking and financial services for State agencies, and maintaining an insurance program for State property and personnel. In addition, STO coordinates the State's general obligation debt functions for the Board of Public Works.

Our audit disclosed that STO had not implemented certain recommendations made by the Maryland Insurance Administration in a January 2011 report to strengthen the State's contract with the Injured Workers' Insurance Fund (IWIF) for claims processing services of workers' compensation claims filed by State employees. Consequently, among other issues, STO had not implemented procedures to verify the propriety of amounts paid to IWIF. Further, the services provided by IWIF had not been subject to a competitive bid process for more than 23 years. During fiscal years 2010 through 2013, payments to IWIF for State workers' compensation claim costs totaled $268.5 million, including $43.1 million for administrative costs.

Interest earnings on State agency bank accounts were not always transferred to the State's General Fund. In addition, STO had not implemented two automated processes to improve controls over the State's disbursements, as recommended by its bank in July 2011.

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STO's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by STO.

Respectfully submitted,

Thomas J. Barnickel III

Thomas J. Barnickel III, CPA
Legislative Auditor

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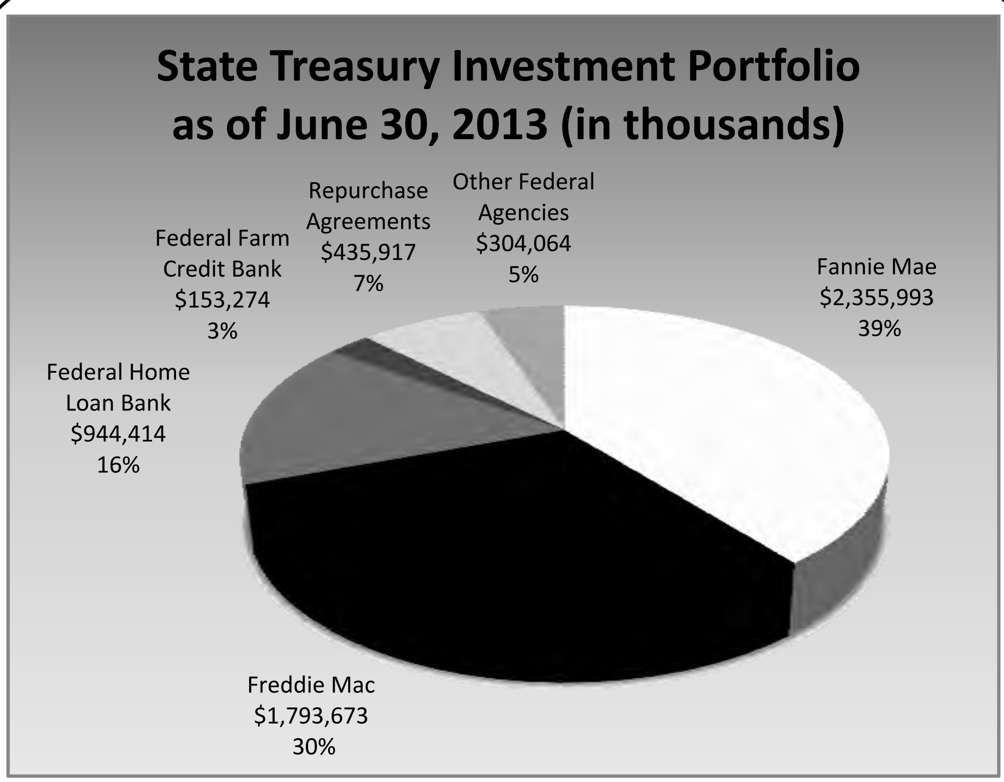
*** Denotes item repeated in full or part from preceding audit report**

Background Information

Agency Responsibilities

The Office of the State Treasurer (STO) is responsible for the receipt, disbursement, safekeeping, and investment of the funds of the State Treasury. It is also responsible for reconciling the related bank accounts, procuring banking and financial services for State agencies, and maintaining an insurance program for State property and personnel. STO also coordinates the State's general obligation debt functions for the Board of Public Works. According to the State's records, STO's operating expenditures for fiscal year 2013 totaled approximately $37 million.

According to State law, State Treasury investments are limited to secured bank accounts, full faith and credit obligations of the federal government, obligations of certain federal agencies or instrumentalities, repurchase agreements collateralized by those securities, certain money market mutual funds, and limited amounts of commercial paper. As of June 30, 2013, the State Treasury investment portfolio, based on market value, totaled approximately $6 billion.



Source: STO's records (unaudited)

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the 12 findings contained in our preceding audit report dated October 27, 2010. We determined that STO satisfactorily addressed 9 of the findings. The remaining 3 findings are repeated in this report.

Findings and Recommendations

Injured Workers' Insurance Fund

Background

Under the terms of a 1990 contract between the Injured Workers' Insurance Fund (IWIF) and the Board of Public Works (BPW), IWIF provides claims processing services for workers' compensation claims filed by State employees. Specifically, IWIF is responsible for investigating, defending, and paying claims to State employees for damages sustained in the course of employment, including injury or death. The State is self-insured for such claims. The contract provides that the Office of the State Treasurer (STO) is responsible for administering the contract, on behalf of BPW. In addition, an amendment to the contract, executed in November 2001, includes provisions that the State shall receive interest earned on amounts paid to IWIF and that the State may fund future costs of incurred losses to mitigate the State's unfunded liability.

Chapter 570, Laws of Maryland, 2012, allowed IWIF to convert from an independent State entity to a fully competitive, private, non-stock, nonprofit insurer. In accordance with the provisions of the law, on October 1, 2013, IWIF became Chesapeake Employers' Insurance Company (CEIC). However, presently IWIF still exists as an instrumentality of the State and the CEIC's Board of Directors and President also serve in those capacities for IWIF.

Under the 2012 law, IWIF's business is limited to serving as the third-party administrator for the State's self-insured workers' compensation program for State employees under a contract with the State. The law allowed IWIF employees at the time of conversion the option to remain State employees under IWIF or become employees of CEIC. IWIF is prohibited from hiring new employees and the law provides that IWIF shall remain in existence until it no longer has any employees.

As required by the contract, at the start of each fiscal year (including fiscal year 2014), STO sent a payment to IWIF for State workers' compensation claim costs for the upcoming year. The payment included an amount to pay for anticipated workers' compensation claims and an amount for IWIF's administrative costs associated with providing claims processing services to the State. Payments for anticipated claims were to be based on the actual amount of claims paid in a prior fiscal year, as reported by IWIF. Payments for administrative costs were to be based on STO's proportionate share of IWIF's administrative costs (allocated based on the State's proportionate share of actual losses compared to actual losses incurred by all clients insured by IWIF, including the State, as reported by IWIF).

According to STO’s records, during fiscal years 2010 through 2013, payments to IWIF for State workers’ compensation claim costs totaled $268.5 million, including $43.1 million for administrative costs. These costs are recovered through State agency assessments prepared by STO.

Finding 1
STO has not implemented recommendations made by the Maryland Insurance Administration to safeguard the State’s interest in its relationship with IWIF.

Analysis
As of December 2013, STO had not taken necessary actions to implement certain recommendations addressing STO’s relationship with IWIF to safeguard the State’s interest. To address our prior audit findings related to IWIF, including STO’s failure to ensure the propriety of amounts paid to IWIF, STO engaged the Maryland Insurance Administration (MIA) to perform a limited scope examination of IWIF. The examination focused on the completeness and accuracy of IWIF’s fiscal year 2010 expenses, including claims and administrative costs charged to the State, and the verification that the allocated costs were fair and reasonable and in compliance with the State’s contract with IWIF. In its resultant report dated, January 19, 2011, MIA reported the State was receiving substantial value from its relationship with IWIF and the amount charged for administrative fees appeared fair and reasonable in relation to the services the State received. However, MIA made the following recommendations to address STO’s relationship with IWIF, which had not been addressed:

- Modify its contract with IWIF to safeguard the State’s financial interest. This would include identifying the actual services to be provided by IWIF and the associated terms governing those services, and modifying the contract periodically for future changes to services and terms. Any modification should also include the identification of specific information that STO feels is necessary to monitor IWIF’s administrative activity and to analyze the cause, frequency, and severity of losses. MIA further recommended that STO consider establishing procedures to ensure that State agencies actually access and use this information to minimize workers’ compensation loss experience. Finally, the contract should specify the amount for catastrophic loss protection so STO can determine if the amount is reasonable. STO paid $1.2 million for catastrophic loss protection in fiscal year 2010.

- Consider using IWIF’s independent auditor to perform agreed-upon procedures reviews to ensure the amounts charged STO for administrative fees, claims, and claims-related charges are accurate and supported. In our two preceding audit reports, we commented that STO did not ensure the propriety of amounts paid to IWIF and recommended that STO review amounts paid to IWIF for propriety, both past payments and in the future. MIA's report concurred with our position and presented this recommendation as one cost-effective method to achieve those results.

- Establish a not-to-exceed amount provision for the IWIF administrative fees to ensure the fees charged the State remain fair and reasonable.

Although both STO and IWIF agreed with MIA's recommendations, STO has delayed taking action to amend the contract pending a decision on whether IWIF will continue to provide workers' compensation claim services to the State (Finding 2). Furthermore, subsequent to the MIA examination of fiscal year 2010 expenses and claims, no procedures had been implemented to assess the propriety of amounts paid to IWIF.

If a decision is ultimately made to continue obtaining these services from IWIF, STO has advised it would execute a new contract with IWIF incorporating MIA's recommendations. If a decision is reached to competitively procure these services, STO advised that it would include those MIA recommendations as appropriate in any request for proposals.

We continue to believe it is STO's responsibility, as administrator of the contract, to take the appropriate actions necessary to implement these recommendations to ensure that the State's workers' compensation claims processing services continue to be fair and reasonable.

Recommendation 1
We recommend that STO implement the aforementioned recommendations to safeguard the State's interest with respect to the workers' compensation claims processing services provided by IWIF. We also recommend that STO, at least on a test basis, review amounts paid to IWIF for propriety (repeat).

Finding 2 (Policy Issue)
The services provided by IWIF have not been subject to a competitive bid process for more than 23 years.

Analysis
The contract to administer workers' compensation claims filed against the State has never been subject to a competitive bid process and IWIF has been providing these services for more than 23 years. The contract contains no specific ending

date, but provides that the State can terminate the contract for any reason after giving IWIF ninety days written notice.

Competitive bids are generally not required for contracts between units of State government. However, as commented upon in our two preceding audit reports, we continue to believe that a competitive bid process should be used to determine if the State is receiving the best value for services rendered by IWIF, especially considering that the payments to IWIF are significant and the same services are available from other insurance companies. Furthermore, due to the 2013 conversion, there is some uncertainty over certain aspects of STO's future relationship with IWIF. For example, we were advised by STO officials that, due to the legislation creating CEIC, beginning in fiscal year 2015, they are unsure if the State will continue to have input on insurance rates and administrative cost rates assessed by IWIF.

STO officials advised that based on the law creating CEIC, which also continued the existence of IWIF, they believe it is the intent of the Maryland General Assembly for IWIF to continue providing such services to the State. Nevertheless, during the course of this audit, STO sought direction from the Maryland General Assembly as to whether the workers' compensation services should be competitively bid. STO advised that if it receives direction to competitively bid the services, it will work with other agencies (such as the BPW and the Department of Budget and Management) to carry out that direction.

Recommendation 2
We recommend that STO take the necessary actions to ensure that workers' compensation claims processing services are obtained in the manner most beneficial to the State (repeat).

Bank Accounts

Finding 3
STO did not ensure interest earnings on State agency bank accounts were transferred to the State's General Fund.

Analysis
STO did not ensure interest earnings on State agency bank accounts were transferred to the State's General Fund. Specifically, STO did not maintain a record of those accounts for which earned interest was required to be transferred to the State, nor had STO established a methodology to determine that interest was being transferred to the State. During fiscal year 2012, STO became aware of

approximately $2 million in accumulated interest earned on State working funds held in a separate interest-bearing bank account that had not been transferred to the General Fund. The interest earned accumulated from December 2005 to December 2011. On February 6, 2012, STO transferred the $2 million to the General Fund. A similar condition was commented upon in our seven preceding audit reports dating back to September 1993.

Contracts between STO and the banks used by State agencies require each bank to invest funds for State agency accounts and to remit interest earnings to the General Fund (via the State's main depository account). During fiscal year 2012, interest earnings on funds in known State agency bank accounts totaling approximately $450,800 (excluding the aforementioned $2 million in working fund interest) were remitted to the General Fund.

Recommendation 3
We recommend that STO ensure that all interest earned on State funds on deposit in agency bank accounts is transferred to the General Fund, as required (repeat).

Finding 4
STO has not implemented recommended automated processes to improve controls over disbursements.

Analysis
STO has not implemented recommended automated processes to improve controls over disbursements. Specifically, when STO awarded the contract for the State's disbursement bank account (including payroll, vendor payments, and tax refunds) on July 1, 2011, the bank had recommended implementing two processes to improve controls over disbursements:

- The bank recommended STO use a controlled disbursement process to precisely determine the daily amount of funds needed in the disbursement account to cover the checks presented for payment. The bank would then obtain the funds from STO for the exact amount of checks paid. This process would also significantly reduce the risk of the disbursement account being overdrawn. Since the controlled disbursement process has not been implemented, currently, STO and the bank estimate the amount of funds needed in the disbursement account on a daily basis. Based on this daily estimate, STO transfers funds from its depository account investments to its disbursement account. However, the estimate is not always accurate resulting in the disbursement account having more funds than needed or being overdrawn for non-sufficient funds.

STO's contract with the bank allows the bank to charge $40 for each non-sufficient fund item paid. According to the bank's invoices, 231,282 non-sufficient funds items were paid by the bank during the period from January 2012 to June 2013. Although the bank has not charged the State for these non-sufficient fund items paid as allowed by the contract, approximately $9.3 million could have been charged.

- The bank recommended STO change from its current positive pay service to a payee positive pay service. With a positive pay service, the bank will only process a check presented for payment if the check date, check number, and amount electronically match with a file of authorized checks submitted by STO. Checks that do not match are considered suspect checks and are reviewed by STO to determine if they should be denied or paid. A payee positive pay service improves this fraud prevention control by adding the payee's name to the criteria in the automated matching process. The Government Finance Officers Association's best practices prefers the implementation of payee positive pay service over a positive pay service on disbursement accounts to help reduce the risk of fraudulent checks.

Although STO management agreed that these are desirable control enhancements, it advised that the controlled disbursement process and payee positive pay service have not been implemented due to staffing resources and technical issues with reprogramming STO's banking system. STO originally estimated that the controlled disbursement process would be implemented by January 2014, but as of March 4, 2014, the process had yet to be finalized. STO could not provide an estimated implementation date for the payee positive pay process.

Recommendation 4
We recommend STO take timely corrective action to implement the aforementioned automated processes to improve controls over disbursements.

Audit Scope, Objectives, and Methodology

We have audited the Office of the State Treasurer (STO) for the period beginning July 1, 2009 and ending August 29, 2012. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine STO's financial transactions, records and internal controls, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. The areas addressed by the audit included monitoring State agency bank accounts, reconciling the State's bank accounts, monitoring payments to the Injured Workers' Insurance Fund, and monitoring the State's securities and investments. The audit also included information systems security and controls, the State Insurance Program, and the Cash Management Improvement Act.

To accomplish our audit objectives, our audit procedures included inquiries of appropriate personnel, inspections of documents and records, observations of the STO's operations, and tests of transactions. We also performed various data extracts of pertinent information from the State's Financial Management Information System (such as revenue and expenditure data) and the State's Central Payroll Bureau (payroll data), as well as from the contractor administering the State's Corporate Purchasing Card Program (credit card activity). The extracts are performed as part of ongoing internal processes established by the Office of Legislative Audits and were subject to various tests to determine data reliability. We determined that the data extracted from these various sources were sufficiently reliable for the purposes the data were used during this audit. Furthermore, we extracted data from STO's automated financial record keeping system for the purpose of testing banking and insurance transactions. We performed various tests of the relevant data and determined that the data were sufficiently reliable for the purposes the data were used during the audit. Finally, we performed other auditing procedures that we considered necessary to achieve our audit objectives. The reliability of data used in this report for background or informational purposes was not assessed.

STO's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect STO's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to STO that did not warrant inclusion in this report.

STO's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise STO regarding the results of our review of its response.

APPENDIX

MARYLAND STATE TREASURER
Nancy K. Kopp

July 7, 2014

Mr. Thomas J. Barnickel III, CPA
Legislative Auditor
Office of Legislative Audits
301 West Preston Street, Room 1202
Baltimore, Maryland 21201

Dear Mr. Barnickel:

Attached is the State Treasurer's Office (STO) response to the draft audit report for the period beginning July 1, 2009 and ending August 29, 2012, which I am pleased to forward for your review.

The Office's responses reflect many significant accomplishments over the past three years since the last Legislative Audit, which can be seen in the significantly lower number of findings in this report. And, indeed, as I trust you will be pleased to see, significant progress continued during the time your staff was auditing the STO and since that time as well.

I would like to take this opportunity to thank the members of the Office of Legislative Audits who spent a great deal of time and effort preparing the audit. They were an impressive, professional team and we appreciated their attention and concern. Needless to say, I would also like to thank the outstanding team at the STO who have accomplished so much with great dedication and determination, despite limited resources.

Sincerely,

Nancy K. Kopp

Nancy K. Kopp
State Treasurer

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State Treasurer's Office Response to Findings and Recommendations

Injured Workers' Insurance Fund

Finding 1
STO has not implemented recommendations made by the Maryland Insurance Administration to safeguard the State's interest in its relationship with IWIF.

Recommendation 1
We recommend that STO implement the aforementioned recommendations to safeguard the State's interest with respect to the workers' compensation claims processing services provided by IWIF. We also recommend that STO, at least on a test basis, review amounts paid to IWIF for propriety (repeat).

Agency Response:

The current agreement between the Board of Public Works and IWIF was renegotiated in 1990. Under that Agreement, IWIF serves as third-party administrator for claims brought against the State under Maryland's Workers Compensation Law.

The Agreement describes three primary responsibilities which involve the Office. The first requires that the Treasurer decide all matters relating to contract administration and performance. The second requires IWIF to submit an annual invoice to the Treasurer reflecting the amount of actual losses incurred by the State, as well as an invoice reflecting the balance of the State's account. The third requires IWIF to compile whatever reports the Treasurer determines to be necessary to:

(a) monitor the performance of the claims administration activity;
(b) assess the financial liability of the program to the State;
(c) project loss experience for the purposes of establishing budgets and agency premiums; and
(d) analyze the causes of losses.

A review of the Board of Public Work's files, including the January 31, 1991 agenda item and transcript, does not reveal any other information defining the requirements of this provision, with the sole exception of a general comment made by Treasurer Maurer to the effect that the Office's Insurance Division was working closely with IWIF. Additionally, there is no record to reflect whether these performance reports have ever been deemed "necessary" or have been requested or produced.

Since the inception of the Agreement in 1990 through the State's FY 15 budget, the Office has served as a conduit to remit payments to IWIF. Since 1990, the Office has received an annual report, via the Department of Budget and Management, that identifies the amount the Governor, through DBM, has proposed and the General Assembly has appropriated, for workers' compensation coverage, including any appropriation for the unfunded liability. The Office prepares a disbursement transmittal, wires this amount to IWIF, and subsequently collects from each agency its share of the appropriated amounts. Historically, any changes to the amount to be remitted to IWIF has been determined by DBM and forwarded to the Treasurer's Office for adjustment.

While the Office has not routinely requested performance reports from IWIF, a report on the State Assessment for Workers' Compensation had been prepared by the Department of Budget and Management, and submitted to the Office. The report reviewed, analyzed and commented on the amounts the State paid and the administrative costs charged by IWIF. In addition, as a State agency, IWIF was subject to periodic Legislative Audits until 2002. It is now subject to audit by the Maryland Insurance Administration. The Office monitors these MIA audits and notes that, to date, there have been no findings questioning the propriety of IWIF premiums or administrative charges.

While the Office agrees that procedures should be in place to safeguard the State's interest, as noted in our response to Finding 2, the Office believes that a public policy decision must be made first as to whether IWIF will continue to provide Worker's Compensation Coverage for the State or whether this service should be competitively bid. Chapter 570 of 2012 allowed IWIF to convert to Chesapeake Employers' Insurance Company, a private, nonprofit and non-stock insurance company. However, the law further provided that IWIF ***may*** (not shall) continue to serve as the State's third party administrator. If the public policy decision is made to continue the State's relationship with IWIF, a new contract will need to be executed and the recommendations from the MIA audit can be incorporated. Because of this law change, changes and updates to the current contract are required. These include, but are not limited to: determining new fee structures for claims and administrative expenses, including caps; cost allocation methodology; handling of the State's Unfunded Liability; the holding and investment of State funds; independent audits; processes utilized to reserve and pay claims; required reporting and verification of data accuracy. If the decision is to competitively bid the services, the State will need to determine what services it wants incorporated in the RFP, which may or may not include all of the MIA recommendations, inasmuch as they specifically addressed the relationship with IWIF.

Finding 2 (Policy Issue)
The services provided by IWIF have not been subject to a competitive bid process for more than 23 years.

Recommendation 2
We recommend that STO take the necessary actions to ensure that workers' compensation claims processing services are obtained in the manner most beneficial to the State (repeat).

Agency Response:

The Office agrees, as it has in our two preceding audits, that this is basically a public policy issue and further, that the policy decision is one for the General Assembly, first, and the Board of Public Works, second, to make. It is not a policy decision to be made by the Office, which simply serves as the administrator for the State's contract with IWIF. This issue includes the determination whether the claims processing services currently being performed by IWIF should be competitively bid.

The history of IWIF as developed by the Office of the Attorney General reflects that the State's workers' compensation claims processing services have *never* been competitively bid. Traditionally, this function has been seen as one performed by a State or quasi-State entity. IWIF's predecessor, the State Accident Fund ("SAF"), was established by the General Assembly in 1914 as the State agency charged with guaranteeing workers' compensation coverage for all of Maryland's employers and their employees. In addition to serving the State, the SAF and its successor, IWIF, have served as workers' compensation insurers of last resort for Maryland employers for 93 years.

Until 1988, the SAF was part of the Department of Personnel. When the Department of Personnel was eliminated and most functions moved to the Department of Budget and Fiscal Management, the SAF functions were moved to IWIF. The Office of Legislative Audits (OLA) conducted regular audits of SAF and IWIF until 2002, when the General Assembly changed the policy and granted IWIF greater autonomy. In fact, it was as a result of OLA recommendations that the General Assembly reorganized the SAF in 1988, and the SAF contract with the State was renegotiated in 1990.

In 2012 the General Assembly again altered the public policy and allowed IWIF to convert from an independent State entity to a fully competitive, private, non-profit insurance company. Even then, however, the law provides that IWIF ***may*** (no shall or shall not) continue to be the third party administrator for the State's Worker's Compensation Program. This is the issue which the Office believes requires clarification.

Although there is no statutory mandate that the State contract with IWIF for workers' compensation claims processing services, it seems to be evident that the intent of the General Assembly over the years is that IWIF provide such services for the State. The General Assembly created IWIF, granted and amended its powers, periodically reorganized its structure and responsibilities, and annually appropriated funds set out in the Governor's budget to pay for its services. In light of the State's historic 93-year relationship with the SAF and IWIF, the Office believes that it would be inappropriate to competitively bid such services absent legislative direction to do so.

The Office has received direction from the General Assembly which confirms the Legislatures intent to allow IWIF to serve as the States' third party administrator for the State's Worker's Compensation Program. The Office will begin working with the BPW to obtain the necessary staff that will be required to negotiate a new contract incorporating a new payment structure and other contract requirements the Treasurer deems to be in the best interest of the State.

Bank Accounts

Finding 3
STO did not ensure interest earnings on State agency bank accounts were transferred to the State's General Fund.

Recommendation 3
We recommend that STO ensure that all interest earned on State funds on deposit in agency bank accounts is transferred to the General Fund, as required (repeat).

Agency Response:

The Office agrees that all interest earned by State agencies on State deposits in their agency bank accounts be transferred to the General Fund. As noted in response to prior audits, we continue to believe that the duty to ensure that this transfer is made is shared between the Office and each State agency using agency bank accounts. Daily operation of these accounts are the responsibility of the individual agencies and their financial officers. Direct oversight by the Office of each interest transfer is impractical due to the very large number of accounts and limited Office staff.

Following the last OLA audit however, in acknowledging our role and responsibility, the Office developed an annual "Bank Account Validation and Interest Certification" to be completed by all State agencies. This new Certification process allows the Office to confirm that all of the accounts reflected on the certifications contain the correct information, including identification as an interest being account, in our Treasury Bank Account Information System (TBAIS).

The Certification identified those 155 accounts out of 1685 that require interest earnings be transferred to the General Fund. Of the 155 accounts, 114 are with three banks (Wells Fargo, M&T and Bank of America) that have a process in place to sweep interest earnings and remit those earnings to the State. For accounts included in the sweep, three individuals in the Banking Services Department review earnings reports submitted by the banks to verify funds are being transferred from the sweep account to the State's main depository. That leaves a remaining 41 accounts at various community banks.

We would note that during the last audit, the Office agreed that, until all accounts are included in an automated process, we would request agencies, on a test basis, to submit proof of interest transfers for verification by the Banking Division. The Office has documentation which confirms the interest transfers as a result of those ongoing tests.

The Office entered into new Agency Depository Contracts in July, 2013. All the agency bank accounts are now included under the legacy contracts or the new Agency Depository Contracts which require the banks to transfer interest earnings to the State's Main Depository on a monthly basis. The Office is working with the banks to make sure that sweep accounts have been established and that the electronic transfer of earnings will occur each month. Our ongoing monthly review of bank reports will allow the Office to verify the electronic interest transfers are happening in accordance with the contract provision.

The Office would note one final point. With the severe decline in interest rates that began in 2009, most of the agency accounts are earning less than $1 per month and in some cases, less than $.50. Since the transaction costs associated with transferring funds to the State in some months has exceeded the interest earned, the Office has made the decision on those occasions to not transfer the interest earnings to the State. The Office believes it is in the State's best interest to allow interest earnings to grow to exceed the transaction costs prior to transferring the funds.

Finding 4
STO has not implemented recommended automated processes to improve controls over disbursements.

Recommendation 4
We recommend STO take timely corrective action to implement the aforementioned automated processes to improve controls over disbursements.

Agency Response:

The specific processes recommended by OLA are controlled disbursement and payee positive pay service. When the RFP for General, Income Tax Refund, and Payroll Disbursement Services was released in 2011, many of the banks recommended additional services not expressly requested in the RFP. Some of the recommended services were for the benefit of the State, some more for the benefit of the banks. This banking services contract was awarded to M&T. M&T made several recommendations regarding many different automated systems intended to improve our disbursement process. The Office, in fact, has been steadily implementing these improvements since the contract was awarded in July of 2011. These systems improvements include, but are not limited to the use of propriety banking systems such as ACH Monitor and Web Info Plus. The Office chose to implement the changes in priority order, starting with those that would save the State the most fees and make the employees more efficient first, while it looked into the IBM mid-range computer programming resources that would be necessary for the other recommended systems and processes. Once the Office had resolved the technical issues of programming multiple overlapping banking programs and completed other priority banking projects, a programmer was assigned full-time to work on controlled disbursement and payee positive pay. Unfortunately, the Office only has two computer programmers, one focuses on daily operating issues which leaves just one to focus on programming new system enhancements. The Office carefully reviews system enhancements and prioritizes them given our limited human resources.

Controlled Disbursement

The State does agree Controlled Disbursement will improve bank controls over disbursements going forward in the new account. We would note, however, that the State issues thousands of checks each day and many of them remain outstanding for years. Therefore, it will still be virtually impossible to "accurately determine" how many checks will clear on any given day until all checks that have been issued from the original account are either cashed or moved to the Unpresented Checks Fund. Even with the implementation of controlled disbursement, the State will continue to pay for check estimation each month until all outstanding checks drawn on the original account have been presented for payment or otherwise accounted for. We would also note that, while check estimates are, indeed, estimates and do not always achieve 100% accuracy, the State, in fact, has not paid any charges for overdrafts and has, indeed, earned interest on funds in excess of the amount needed on any given day.

The Office has completed all of the necessary programming and has been ready to convert to the Controlled Disbursement Account since December 2, 2013. We submitted all of the required forms to M&T and were waiting for the bank to open the required account which was completed in April. Once the account was opened we were advised by M&T that they would require an additional 30+ days to test in their live system. Given the additional time required by the bank to set-up the account and, test in their system, the Office decided to implement controlled disbursement at the beginning of the new fiscal year. The Office implemented Controlled Disbursement effective July 1, 2014.

Payee Positive Pay

a) The Office currently utilizes Positive Pay with M&T. Under our current system, the Office sends the bank a positive pay file that contains the check date, check number and amount. As the Auditor notes, the bank will only pay checks that match the electronic file that has been sent to the bank. Converting to Payee Positive Pay will include the payee as an additional field the bank will match prior to paying a State check. We would note that in the current environment, with the utilization of Positive Pay, if a fraudulent check is presented, it is denied through the daily review of suspect checks. The Office agrees that Payee Positive Pay is an additional tool to assist the bank in fraud prevention and implemented this enhancement effective May 1, 2014.

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