STATE OF ILLINOIS
OFFICE OF THE
AUDITOR GENERAL
Frank J. Mautino, Auditor General

SUMMARY REPORT DIGEST

ILLINOIS WORKERS' COMPENSATION COMMISSION
SELF-INSURERS SECURITY FUND

Financial Audit
For the Year Ended June 30, 2016

Release Date: January 11, 2018

FINDINGS THIS AUDIT: 3	New	Repeat	Total
Category 1:	3	0	3
Category 2:	0	0	0
Category 3:	0	0	0
TOTAL	3	0	3

FINDINGS LAST AUDIT: 0

AGING SCHEDULE OF REPEATED FINDINGS			
Repeated Since	Category 1	Category 2	Category 3
No Repeat Findings			

INTRODUCTION

This digest covers the Fund's financial audit as of and for the year ended June 30, 2016. The auditors expressed an **adverse opinion** on the Fund's basic financial statements. The Codification of Statements on Auditing Standards (AU-C § 705.09) states auditors "should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements." A compliance examination of the entire Commission for the two years ended June 30, 2017, will be started later this year.

SYNOPSIS

- (**16-01**) The Commission did not exercise adequate internal control over its financial reporting.
- (**16-02**) The Commission had an inadequate process to determine the claims liabilities of the Fund.
- (**16-03**) The proper accounting treatment for an insolvent self-insurer's security collected by the Commission is not determinable due to two different irreconcilable interpretations of the Workers' Compensation Act.

EMPHASIS OF MATTER

During our audit, we noted the Self-Insurers Administration Fund's expenses have exceeded revenues recognized for a significant period of time.

Category 1:	Findings that are **material weaknesses** in internal control and/or a **qualification** on compliance with State laws and regulations (material noncompliance).
Category 2:	Findings that are **significant deficiencies** in internal control and **noncompliance** with State laws and regulations.
Category 3:	Findings that have **no internal control issues but are in noncompliance** with State laws and regulations.

{Expenditures and Activity Measures have been excluded due to the adverse opinion on the Fund's financial statements.}

<u>**FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS**</u>

INADEQUATE FINANCIAL ACCOUNTING AND REPORTING

The Illinois Workers' Compensation Commission (Commission) did not exercise adequate internal control over its financial reporting for the Self-Insurers Security Fund (Fund).

Material and Pervasive Misstatement

Inadequate process to determine claims liabilities

During testing, the auditors noted the Commission had an inadequate process to determine the claims liabilities of the Fund.

Material and Pervasive Inability to Obtain Sufficient and Appropriate Evidence

Proper accounting treatment undeterminable due to two irreconcilable statutory interpretations

During testing, the auditors noted the proper accounting treatment for an insolvent self-insurer's security collected by the Commission is not determinable due to two different irreconcilable interpretations of the Workers' Compensation Act (Act).

Basis for an Adverse Opinion

Adverse Opinion

As a result of (1) the Commission not adopting a more robust process to determine the estimated claims liabilities of the Fund and (2) our inability to obtain sufficient and appropriate audit evidence regarding the proper accounting treatment for an insolvent self-insurer's security under the Act, the auditors expressed an adverse opinion on the Fund's financial statements as of and for the year ended June 30, 2016.

Other Noted Errors Corrected by the Commission

In addition to the foregoing conditions that resulted in an adverse opinion on the Fund's financial statements as of and for the year ended June 30, 2016, we noted other financial reporting problems that were corrected in the Fund's final financial statements by the Commission. Some of the more significant matters included the following:

Incorrect 20% markup on the Fund's claims liabilities

- The Commission changed the Fund's methodology for calculating claims accruals by eliminating a 20% markup and additional reserve for claims. The auditors determined the Commission did not have (1) a reasonable basis for the markup or (2) documentation to support why the 20% markup was included within its claims accrual methodology. This change resulted in the Fund recording a prior period adjustment of $796,388 and a current period adjustment of $133,610.

Loss exposure incorrectly reported

- The Commission recorded a prior period adjustment of $235,416 for a loss exposure recorded in the prior year that did not meet the requirement that a liability must have been incurred as of the date of the financial statements.

Unrecorded liabilities

- The Commission changed its longstanding accounting policy for claims liabilities to include claims liabilities for insolvent self-insurers whose unpaid claims were less than the security collected by the Commission from those self-insurers. This policy change resulted in the Fund recording a prior period adjustment of $2,799,100 and a current period adjustment of $207,060.

Prior period adjustment for an improperly recorded refund

- The Commission recorded a prior period adjustment of $100,000 to increase the Fund's beginning net position and reduce its unearned security deposits liability account. This adjustment was needed to reflect a refund previously incorrectly recorded as an operating expense during a prior year as opposed to a reduction to the unearned security deposit liability account.

Current period adjustments for improperly recorded refunds

- The Commission recorded a current period adjustment of $508,000 to reduce the Fund's current operating expenses and unearned security deposits liability account. This adjustment was needed to reflect refunds incorrectly recorded as an operating expense as opposed to a reduction to the unearned security deposits liability account. (Finding 1, pages 23-28)

Auditor's recommendation

We recommended the Commission, in conjunction with the Self-Insurers Advisory Board, take action to:

1) adopt written accounting policies which conform to accounting principles promulgated by the Governmental Accounting Standards Board for enterprise funds;
2) develop an appropriate process to estimate the claims liabilities of the Fund based upon sufficient and reliable evidence;
3) seek a formal, written opinion from the Attorney General regarding the treatment of an insolvent self-insurer's security under the Act, or seek a legislative remedy; and,
4) identify financial reporting problems and make any necessary adjustments to the financial statements and related notes prior to the post audit process.

Commission officials agree

The Commission agreed with this recommendation.

INADEQUATE PROCESS TO DETERMINE CLAIMS LIABILITIES

The Commission had an inadequate process to determine the claims liabilities of the Fund.

Background

The Self-Insurers Advisory Board (Board) within the Commission was established by the Workers' Compensation Act (Act) to provide oversight of self-insurers, ensure the employees of insolvent self-insurers continue to receive their benefits due under the Act and the Workers' Occupational Diseases Act (together, the "Acts") by administering the Fund, and determining the assessments to levy against all private self-insurers to ensure resources are available to continue paying benefits due to employees of insolvent self-insurers.

Fund exists to ensure employees of insolvent self-insurers continue to receive benefits due to them

If a self-insurer becomes insolvent and can no longer pay its workers' compensation obligations, the Board assumes the outstanding obligations under the Acts of the insolvent self-insurer and takes action to collect, recover, and enforce all of the various forms of security provided by the insolvent self-insurer. The Board then directs the Commission to deposit resources derived from the security into the Fund.

Board assumes obligations of insolvent self-insurers

Commission collects the insolvent self-insurer's security

The Fund will continue to pay, in full, the insolvent self-insurer's obligations due under the Acts as long as the insolvent self-insurer's employees remain disabled. Due to the nature of workers compensation claims, these costs can extend out over several decades and remain subject to a wide variety of factors impacting the actual cost of the obligation due to the employees, including necessary medical procedures, cost inflation, and each employee's life expectancy.

Claims can extend out over several decades

Review of Accounting Principles Generally Accepted in the United States

Governmental Accounting Standards Board Statement No. 34 requires the presentation of proprietary funds, such as the Fund, under the accrual basis of accounting and the economic resources measurement focus. Further, Governmental Accounting Standards Board Statement No. 34 notes transactions occur when something of value passes between two or more parties. Additionally, National Council on Governmental Accounting Statement No. 1 states that under the accrual basis of accounting, transactions are generally recorded when the transaction occurs, regardless of when cash is received or disbursed.

Accrual basis reporting focuses on when a transaction occurs, regardless of when cash is received or disbursed

Also, Governmental Accounting Standards Board Statement No. 62 requires estimated losses be accrued if both (1) information available prior to the issuance of the financial statements indicates it is probable a liability has been incurred as of the date of the financial statement and (2) the amount of the loss can be reasonably estimated. If either or both of these

Accounting standards requires accrual of estimated losses or disclosure in the notes

conditions cannot be satisfied, Governmental Accounting Standards Board Statement No. 62 requires the exposure be disclosed in the notes to the financial statements.

Application of the Accounting Literature to the Fund's Environment

Fund needs to account for incurred but not reported claims and administrative costs

As such, the Fund must develop an accounting methodology to properly account for incurred but not reported (IBNR) claims liabilities and the associated administrative costs necessary to continue processing the amounts due to the employees over time as of the date when it is both (1) probable a liability has been incurred and (2) the amount can be reasonably estimated or disclose the situation in the Fund's notes if one or both conditions are not met. This is necessarily an accounting estimate and impacts the Board's determination of assessments needed to ensure the Fund has sufficient resources to carry out its activities under the Act.

Fund's claims liability generally reflects cash or modified accrual basis accounting

Accrual basis accounting required

We noted the Commission's current methodology for its claims liability generally reflects cash basis or modified accrual basis accounting for the Fund's unpaid medical claims and unpaid administrative and legal expenses. These liabilities must be reported on the full accrual basis of accounting.

Recommended development of a claims reserve analysis to estimate the net unpaid claims liability

During the audit process, we recommended the Commission adopt a claims reserve analysis to properly estimate the Fund's net unpaid claims liability. This process would calculate both known claims (such as established rates for indemnity payments) and IBNR claims where actuarial techniques are used to calculate the total liability of each individual claim from an insolvent self-insurer's employees and recognize that expense in the period when it becomes probable a liability has been incurred. When these claims are ultimately paid from the Fund, the Fund would reduce its already recorded liability for unpaid claims.

Methodology to calculate the Fund's unpaid claims liability

A formula for determining the Fund's net claims liability from each claim is:

Add:	Gross Unpaid Indemnity Claims
	Gross Unpaid Medical Claims
	Gross Unpaid Administrative and Legal Expenses
Less:	Excess Insurance Recoveries
	Security Collected from Insolvent Self-Insurers
	Recognized Net Unpaid Claims Liability

Material and Pervasive Misstatement

Board and Commission ultimately did not adopt a claims reserve analysis

After extensive discussions between the auditors and the Commission, the Board and Commission ultimately did not adopt a claims reserve analysis approach to calculate claims liabilities in accordance with the accrual basis of accounting. The Board and Commission kept its prior claims methodology which did not reflect the accrual basis of accounting. (Finding 2, pages 29-33)

Auditor's recommendation

We recommended the Commission, in conjunction with the Board, take action to ensure its claims liabilities, including the Fund's unpaid medical claims and unpaid administrative and legal expenses, are properly presented in accordance with the accrual basis of accounting.

Commission officials agree

The Commission agreed with this recommendation.

UNCERTAINTY REGARDING STATUTORY INTERPRETATION

The proper accounting treatment for an insolvent self-insurer's security collected by the Commission is not determinable due to two different irreconcilable interpretations of the Act.

Background

An employer can apply to the Self-Insurers Advisory Board (Board) within the Commission to become a self-insurer under the Act. During its review of the application, the Board considers several factors – including the applicant's financial viability, number of employees, the nature and hazard of the types of work performed by its employees, and claims experience factors – to reach its decision to approve or deny the application. If the Board approves the applicant, the Board will determine if the self-insurer has sufficient ability to adequately secure payment for its financial obligations under the Acts or require the self-insurer to post a security. Typically, the Board requires the self-insurer to post some form of security – such as a surety bond, escrow agreement, or letter of credit – to allow the Commission to obtain resources to cover a self-insured employer's obligations under the Acts if it becomes insolvent.

Board assumes obligations of insolvent self-insurers

Commission collects the insolvent self-insurer's security

If a self-insurer becomes insolvent and can no longer pay its workers' compensation obligations, the Board assumes the outstanding obligations under the Acts of the insolvent self-insurer and takes action to collect, recover, and enforce all of the various forms of security provided by the insolvent self-insurer. The Board then directs the Commission to deposit resources derived from the security into the Fund.

Claims can extend out over several decades

Amount due to an injured employee impacted by medical procedures needed, inflation, and life expectancy

The Fund will continue to pay, in full, the insolvent self-insurer's obligations due under the Acts as long as the insolvent self-insurer's employees remain disabled. Due to the nature of workers' compensation claims, these costs can extend out over several decades and remain subject to a wide variety of factors impacting the actual cost of the obligation due to the employees, including necessary medical procedures, cost inflation, and each employee's life expectancy. As such, the security collected by the Commission from the insolvent self-insurer may or may not ultimately satisfy the insolvent self-insurer's workers compensation claims. In order to ensure the Fund can fulfill these obligations if the collected security is

Assessments of private self-insurers cover amounts due to injured employees where the collected security was insufficient

insufficient, the Act provides a procedure for the Board to assess each private self-insurer a pro rata share of the funding reasonably necessary to ensure the Board can fulfill its obligations to the insolvent self-insurer's employees.
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Two irreconcilable interpretations of how to handle the security of an insolvent self-insurer

At this point, two irreconcilable interpretations of the Act exist with regards to the proper treatment of the security collected by the Commission from the insolvent self-insurers.

Interpretation #1 – Liability Recognized Upon Receipt
Interpretation #1 assumes the Act has two separate and distinct refund criteria codified for insolvent self-insurers when its obligations have been satisfied and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied.

Interpretation #2 – Revenue Recognized Upon Receipt
Interpretation #2 assumes the Act has two separate refund criteria codified for insolvent self-insurers when its obligations have been satisfied and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied, but both criteria only occur when the entire Fund ceases operations and all obligations have been fully satisfied. It is readily assumed the complete cessation of the Fund is extremely remote, as businesses voluntarily choose to become self-insurers and participate in the assessment process for various economic reasons.

Our report analyzed the relative strengths and weaknesses of each interpretation

Within the finding, we analyzed both interpretations and identified various strengths and weaknesses for each interpretation. We also identified the accounting treatments that would arise if either Interpretation #1 or Interpretation #2 was adopted by the Fund.

Resolution needed to determine the Fund's net position (deficit)

Due to these two irreconcilable interpretations of the Act, we were unable to obtain sufficient, appropriate audit evidence to conclude the Commission's presentation of the Fund's financial statements complied with the Act. According to Commission officials, the implementation of the Interpretation #1 would result in the Fund reducing its recognition of revenue in current and prior periods of approximately $16.9 million, which would result in the Fund showing a negative net position of approximately $5.4 million. (Finding 3, pages 34-44)

Auditor's recommendation

We recommended the Board and the Commission seek a formal, written opinion from the Attorney General regarding the treatment of an insolvent self-insurer's security under the Act, or seek a legislative remedy.

Commission officials agreed to seek a legislative remedy

The Commission agreed with the recommendation to seek a legislative remedy.

We will review the Commission's progress towards the implementation of our recommendations in our next financial audit.

EMPHASIS OF MATTER

Expenses have exceeded revenues for several years

Without operational changes and/or a legislative remedy, the continuing negative trend will eventually consume the remaining net position.

The State of Illinois' self-insurance program administered by the Commission consists of two funds: the Self-Insurers Administration Fund and the Self-Insurers Security Fund. Pursuant to the Act, the Self-Insurers Administration Fund collects a $500 application fee from each private self-insurer applying for or seeking renewal of the self-insurance privilege, which is available only for paying the salaries and benefits of the employees and the operating costs of the Self-Insurers Advisory Board within the Commission. During our audit, we noted the Self-Insurers Administration Fund's expenses have exceeded revenues recognized for a significant period of time. According to the Commission's most recent unaudited accrual basis financial reports filed with the Office of the State Comptroller, the Self-Insurers Administration Fund's net loss was $157 thousand, $132 thousand, and $86 thousand during Fiscal Year 2015, Fiscal Year 2016, and Fiscal Year 2017, respectively. Without operational changes and/or a legislative remedy, the continuing negative trend will eventually consume the remaining net position, which the Commission's unaudited accrual basis financial reports filed with the Office of the State Comptroller reported was $304 thousand at June 30, 2017.

AUDITOR'S OPINION

The auditors stated the financial statements of the Fund as of and for the year ended June 30, 2016, are not fairly stated in all material respects.

This financial audit was conducted by Adelfia LLC.

SIGNED ORIGINAL ON FILE

JANE CLARK
Division Director

This report is transmitted in accordance with Section 3-14 of the Illinois State Auditing Act.

SIGNED ORIGINAL ON FILE

FRANK J. MAUTINO
Auditor General

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