OFFICE OF THE

CITY AUDITOR

AN AUDIT OF THE CITY OF SAN JOSE'S INVESTMENT OF WORKERS' COMPENSATION PROGRAM FUND RESERVES

– THE WORKERS' COMPENSATION FUND'S INVESTMENT EARNINGS CAN BE INCREASED BY AN ESTIMATED $235,000 PER YEAR AND THE FUND'S FINANCIAL STATEMENT LIABILITY REDUCED BY $2.1 MILLION WITHOUT JEOPARDIZING THE FUND'S FISCAL INTEGRITY

A REPORT TO THE

SAN JOSE

CITY COUNCIL

DECEMBER 1993

93-10

CITY OF SAN JOSÉ, CALIFORNIA

GERALD A. SILVA
City Auditor

151 W. MISSION STREET, ROOM 109
SAN JOSE, CALIFORNIA 95110
(408) 277-4601

December 3, 1993

Honorable Mayor and Members
of the City Council
801 North First Street, Room 600
San Jose, CA 95110

Transmitted herewith is a report on *An Audit Of The City Of San Jose's Investment Of Workers' Compensation Program Fund Reserves*. This report is in accordance with City Charter Section 805.

An Executive Summary is presented on the blue pages in the front of this report while an Administration response is shown on the yellow pages before the Appendices.

I will present this report to the Finance Committee at its December 8, 1993, meeting. If you need additional information in the interim, please let me know. The City Auditor staff members who participated in the preparation of this report are Nestor Baula, Sharon Erickson, and Robin Klenke.

Respectfully submitted,

Gerald A. Silva

Gerald A. Silva
City Auditor

finaltr
GS:mtn

cc: Les White
Regina Williams
Sherry Langbein
Joan Gallo
Larry Lisenbee
John Guthrie
Mark Burton
Errol Fitzpatrick
David Wong
Jessica Batinich

OFFICE OF THE

CITY AUDITOR

AN AUDIT OF THE CITY OF SAN JOSE'S INVESTMENT OF WORKERS' COMPENSATION PROGRAM FUND RESERVES

A REPORT TO THE

SAN JOSE

CITY COUNCIL

TABLE OF CONTENTS

LIST OF CHARTS, GRAPHS, AND TABLES

EXECUTIVE SUMMARY

In accordance with the City Auditor's 1993-94 Audit Workplan, we have audited the city of San Jose's (City) investment of Workers' Compensation Program (Program) fund reserves. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

THE WORKERS' COMPENSATION FUND'S INVESTMENT EARNINGS CAN BE INCREASED BY AN ESTIMATED $235,000 PER YEAR AND THE FUND'S FINANCIAL STATEMENT LIABILITY REDUCED BY $2.1 MILLION WITHOUT JEOPARDIZING THE FUND'S FISCAL INTEGRITY

The Workers' Compensation Fund (Fund) is pooled with other City funds for investment purposes. As of June 30, 1993, these pooled funds had an average maturity of 361 days and interest earnings of 4.765 percent. However, our review revealed that Fund reserves can be safely invested for much longer periods of time and thus realize additional interest earnings because

- The Fund has cash reserves of about $32 million which theoretically can be invested for an indefinite period of time provided the City's biweekly payroll contributions to the Fund continue to cover ongoing Fund payouts and

- The State Compensation Insurance Fund has its cash reserves invested in instruments with an average maturity that is nearly 10 years longer than the City's and produces interest earnings of 6.25 percent.

As a result, we estimate that the Fund could safely realize about $235,000 in additional interest earnings per year and the Fund's estimated financial statement liability could be reduced by about $2.1 million if the City separately invested the Fund's cash reserves in longer maturity instruments.

RECOMMENDATIONS

We recommend that the City Council:

Recommendation #1:

Adopt an investment policy that allows the Administration to separately invest Workers' Compensation Fund reserves in instruments with longer maturities. (Priority 1)

Furthermore, we recommend that the Finance Department:

Recommendation #2:

Annually review and recommend to the City Council workers' compensation payroll rates that will generate sufficient cash flows to the Workers' Compensation Fund to cover expected claims costs, operating expenses, and any additional amounts deemed necessary to effectuate the City's workers' compensation funding policy. (Priority 3)

INTRODUCTION

In accordance with the City Auditor's 1993-94 Audit Workplan, we have audited the city of San Jose Workers' Compensation Program. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

The City Auditor's Office thanks the Risk Management Unit, specifically the Risk Manager, the Workers' Compensation Manager, and the entire staff in the Workers' Compensation section of the Risk Management Unit who gave their time, information, insight, and cooperation for this audit.

SCOPE AND METHODOLOGY

This is the first of three audit reports on the city of San Jose (City) Workers' Compensation Program (Program). This report will focus on investment of fund reserves; the second report will focus on estimating the outstanding liability; and the third report will address cost containment methods for the Program. Our methodology included interviews with City personnel in the Workers' Compensation Section, Finance Department, Accounting Section, and Office of Management and Budget and meetings with the City's external auditors and actuaries. In addition, we

- Conducted interviews with industry experts;
- Analyzed summary and detail data reports;
- Reviewed actuarial reports;
- Assessed the adequacy of reserves; and
- Evaluated payroll rates for appropriateness, accuracy, and the capability to pay current and future claims liabilities.

BACKGROUND

Department Mission

The mission of the Finance Department in administering the Workers' Compensation Program (Program) within their Risk Management Unit is *"to operate a self-insured program providing State-mandated benefits to City employees for work-related injuries and illnesses more economically than is possible through a State-insured program."*

In addition, the specific goals of the Risk Management Unit are

> *TO serve both the public and the City organization by identifying risks and minimizing or transferring those risks in order to protect the assets of the City and to preserve the well-being of citizens and City employees.*
>
> *TO uniformly provide Workers' Compensation Benefits in accordance with the State of California Labor Code and in conjunction with the Memorandums of Agreement as well as other applicable City policies and procedures. These benefits are to be provided while exercising fairness in working with all parties in a timely, cost-effective, and professional manner.*

Department Organization

The Program is administered by the Risk Management Unit of the Finance Department. Chart I shows the organization of the unit as of September 1992. It should be noted that as of September 1993, the Program has lost two positions--one staff technician and one senior account clerk.

CHART I

ORGANIZATION CHART

A new management team has been put into place over the past few years. The Risk Manager position had been vacant for nearly two years when it was filled in July 1992. The Workers' Compensation Manager position was vacant for almost one and a half years before it was filled in June 1991. In addition, the Director of Finance position was vacant during the same period.

Revenue

Funding for the City's Workers' Compensation Fund (Fund) comes from four sources, (1) reimbursement from City funds, (2) investment interest earnings, (3) reimbursement from the State Compensation Insurance Fund, and (4) subrogation recovery. Revenues from the State Compensation Insurance Fund and subrogation recovery are extremely difficult to estimate as they are very unpredictable from year to year. Table I summarizes recent fund activity.

TABLE I

WORKERS' COMPENSATION FUND ACTIVITY
FROM 1986-87 THROUGH 1992-93 (In Millions)

	1986-87 Actual	1987-88 Actual	1988-89 Actual	1989-90 Actual	1990-91 Actual	1991-92 Actual	1992-93 Estimated
REVENUES							
Reimbursement from City funds	$11.5	$ 9.5	$ 7.9	$ 7.9	$ 7.7	$ 9.6	$ 9.8
Interest	2.2	2.5	3.0	2.6	2.2	1.8	1.7
Received from other sources	0.3	0.2	0.1	0.8	0.5	0.2	0.1
TOTAL REVENUES	$14.0	$12.2	$11.0	$11.3	$10.4	$11.6	$11.6
EXPENSES							
Operating expenses	$0.8	$0.8	$ 0.8	$1.5	$1.5	$ 1.5	$ 1.7
Payment of claims	5.9	5.0	5.9	8.0	8.4	10.3	10.2
Net adjustment to accrued liability[1]	14.5	7.0	(19.0)	(2.0)	0.3	5.9	11.0
TOTAL EXPENSES	21.2	12.8	(12.3)	7.5	10.2	17.7	22.9
TRANSFER IN (OUT)[2]	(2.0)	(2.2)	0.0	0.0	(4.9)	5.7	0.0
NET INCOME (LOSS)	$(9.2)	$(2.8)	$23.3	$3.8	$(4.7)	$5.7	$(11.3)

Reimbursement From City Funds

The primary income stream for the Fund comes directly from each department's personal service budget and is based on payroll rates calculated for employees in five categories: police, fire, clerical, manual, and non-manual. At

---

[1] In the financial statements, "adjustments to the accrued liability" appear in the "payment of claims" line.

[2] Interfund transfers are listed separately from revenues and expenses in the financial statements. The effect of a transfer is a change in retained earnings which, in turn, affects fund equity. A "transfer out" will decrease retained earnings. A "transfer in" will increase retained earnings.

According to the Finance Department, of the $4.9 million that was transferred out of the Workers' Compensation Fund in 1990-91, $1 million was transferred to the General Fund and $3.9 million was transferred to the General Liability Fund. Then in 1991-92, the City transferred $5.7 million from the General Liability Fund into the Workers' Compensation Fund.

year-end 1992-93, reimbursement from City funds was estimated to be $9.8 million.

Interest Earnings

Investment interest earnings are the main external source of revenue for the Fund. As of June 30, 1993, cash reserves for outstanding claims total approximately $32 million. These funds are invested with the City's pooled investments. For 1992-93, interest earnings were estimated at $1.7 million.

Reimbursement From The State

As a result of City participation in the State Compensation Insurance Fund prior to July 1974, the City continues to receive revenues in the form of reimbursements for pre-1974 claims that remain open. As of June 30, 1993, there were only four such open claims. In addition, if an employee with a pre-1974 claim was re-injured in later years and that injury is deemed to be related to the pre-1974 injury, that may also be a reimbursable claim. As deaths, retirements, and closed cases occur over the years, the payout from the State Compensation Insurance Fund has become less and less and is not predictable.

Subrogation

When an industrial injury is caused by the negligence or intentionally wrongful act of some person other than the employer, the injured employee has two rights (causes of action): (1) the right to workers' compensation benefits and (2) the right to sue the wrongdoer for damages in a court action. However, these rights are governed so as to give the employee only the greater of the two recoveries. The damage suit is called a "third-party action." The City, as employer, also has a right to sue the wrongdoer for damages which consist of any compensation payments made to the employee. In this respect, the employer is said to be "subrogated" to the rights of the employee whom it insures. The number of third-party actions that will occur in a fiscal year is unpredictable as is the total of their potential settlement awards. Therefore, revenues from this source are also difficult to estimate.

Major Accomplishments Relating To The Program

In Appendix B, Program management informs us of accomplishments related to the Program. According to Program management, it has

- Implemented a claims management database system as of July 1991;
- Achieved salary savings in claims administration through elimination of all contract workers as of October 1991;
- Enhanced and corrected claims computer data through several major efforts;
- Revised reserving policies and implemented guidelines for staff; and
- Implemented a cost containment program in October 1993.

Furthermore, Program management has informed us that it is

- Increasing efforts in the safety education process by developing training programs customized to reduce specific injury trends and
- Evaluating the use of an individual portfolio of investment funds for the Workers' Compensation Fund.

Appendix B contains the full text of the memorandum.

FINDING I

THE WORKERS' COMPENSATION FUND'S INVESTMENT EARNINGS CAN BE INCREASED BY AN ESTIMATED $235,000 PER YEAR AND THE FUND'S FINANCIAL STATEMENT LIABILITY REDUCED BY $2.1 MILLION WITHOUT JEOPARDIZING THE FUND'S FISCAL INTEGRITY

The Workers' Compensation Fund (Fund) is pooled with other city of San Jose (City) funds for investment purposes. As of June 30, 1993, these pooled funds had an average maturity of 361 days and interest earnings of 4.765 percent. However, our review revealed that Fund reserves can be safely invested for much longer periods of time and thus realize additional interest earnings because

- The Fund has cash reserves of about $32 million which theoretically can be invested for an indefinite period of time provided the City's biweekly payroll contributions to the Fund continue to cover ongoing Fund payouts and

- The State Compensation Insurance Fund has its cash reserves invested in instruments with an average maturity that is nearly 10 years longer than the City's and produces interest earnings of 6.25 percent.

As a result, we estimate that the Fund could safely realize about $235,000 in additional interest earnings per year and the Fund's estimated financial statement liability could be reduced by about $2.1 million if the City separately invested the Fund's cash reserves in longer maturity instruments.

Workers' Compensation Fund Reserves Are Pooled With Other City Funds For Investment Purposes

As of June 30, 1993, the Fund had approximately $32 million equity in pooled cash and investments held in the City treasury. As such, Fund reserves are invested along with other available City cash issues in the City's Pooled Investment Fund. As of June 30, 1993, the weighted average days to maturity for the City's Pooled Investment Fund was 361 days with an effective rate of return on investment of 4.765 percent. The City's current investment policy states:

> *As a general rule, the average maturity of the investment portfolio will not exceed two years, and no investment will have a maturity of more than five years from its date of purchase.*

Our review revealed that the City can safely invest the $32 million in Fund reserves in instruments with much longer maturities and earn higher rates of return on investment for two reasons. First, the City theoretically would not have to actually use the $32 million in Fund reserves provided the City's biweekly payroll contributions to the Fund continue to cover ongoing Fund payments. Second, we found that the State Compensation Insurance Fund has its reserves invested in instruments with an average maturity that is nearly 10 years longer than the City's and resultant interest earnings that are 31 percent higher.

Fund Reserves Of $32 Million Theoretically Can Be Invested For An Indefinite Period Of Time

The primary income stream to pay current liabilities for workers' compensation claims comes from payroll rates which are calculated annually for employees in five categories--police, fire, clerical, manual, and non-manual workers--and applied biweekly to the City payroll. The rates are calculated for each category of employees based on the past three to four years of actual expenses by payroll category. The City's payroll system applies the rates to the biweekly payroll and generates a transfer from personal services budgets to the Fund. The City's method of calculating payroll rates, using 1991-92 as the example year, follows.

CALCULATION OF ESTIMATED 1991-92 PAYROLL REQUIREMENT

Expected incurred costs 1991-92	$10,700,000
Excess (shortfall) in prior estimates	0
Plus administrative costs	1,348,513
Less expected interest income	(1,617,617)
Less projected recoveries	(390,000)
Less adjustment for temporary disability*	(760,000)
Net Fund Requirement	$ 9,280,896

* Temporary disability is paid out of budgeted personal services appropriations, not the Fund.

CALCULATION OF FUND PAYOUTS AND PERCENTAGE OF FUND PAYOUTS FOR PREVIOUS FOUR YEARS BY WORKERS' COMPENSATION JOB CLASSIFICATIONS

	Fire (7706)	Police (7720)	Clerical (8810)	Non-Manual (9410)	Manual (9420)	Total
1986-87	$2,562,360	$ 3,908,209	$ 349,715	$ 695,579	$1,639,067	$ 9,154,930
1987-88	2,238,296	3,463,859	455,467	141,667	1,357,262	7,656,551
1988-89	2,346,168	3,329,659	394,957	375,619	890,236	7,336,639
1989-90	2,028,046	2,432,069	608,761	484,814	1,343,181	6,896,871
	$9,174,870	$13,133,796	$1,808,900	$1,697,679	$5,229,746	$31,044,991
Total Fund Payout	29.55%	42.31%	5.83%	5.47%	16.85%	100%

* Totals are slightly off due to rounding.

NET FUND REQUIREMENT APPORTIONED BY JOB CLASSIFICATION

	Fire	Police	Clerical	Non-Manual	Manual
Total Fund Payout For Previous Four Years	29.55%	42.31%	5.83%	5.47%	16.85%
Net Fund Requirement	$9,280,896	$9,280,896	$9,280,896	$9,280,896	$9,280,896
Fund Requirement By Job Classification	$2,742,826	$3,926,347	$540,770	$507,521	$1,563,432

CALCULATION OF PAYROLL RATES BY JOB CLASSIFICATION

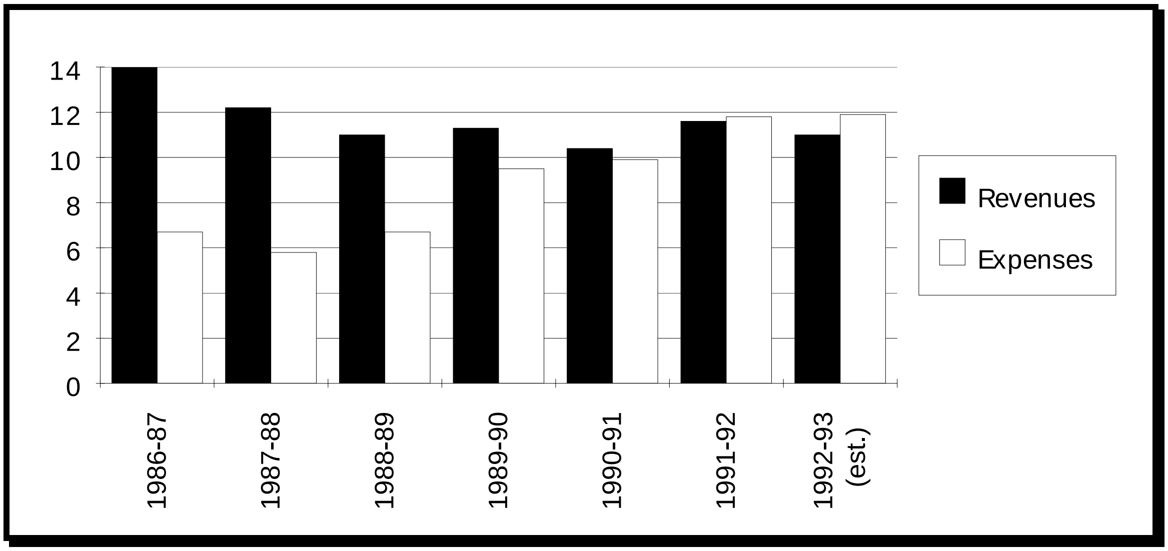
	Fire	Police	Clerical	Non-Manual	Manual
Fund Requirement By Job Classification	$2,742,826	$3,926,347	$540,770	$507,521	$1,563,432
Projected Yearly Payroll	$34,336,982	$62,422,692	$65,032,947	$51,318,773	$40,406,282
Calculated Payroll Rates By Job Classification	7.99%	6.29%	.83%	.99%	3.87%

By basing rates on actual Workers' Compensation Program (Program) costs, the above method causes departments with the highest claims payments to pay more into the Fund. For example, the Police and Fire Departments were budgeted to contribute 72 percent of 1991-92 departmental contributions to the Fund. This was based on the fact that 72 percent of claims payments during the previous four years were from the Police and Fire Departments.

If the City's workers' compensation payroll rates generate sufficient cash flows to cover expected claims costs and operating expenses, Fund reserves need not be used. In other words, if operating revenues and expenditures are close to a break-even for the year, Fund reserves may not be needed at all during a given year. Under this scenario, reserves in the Fund could be safely invested for a longer term. Our review revealed that Fund revenues have exceeded expenditures in five of the past seven years, as shown in Graph I.

GRAPH I

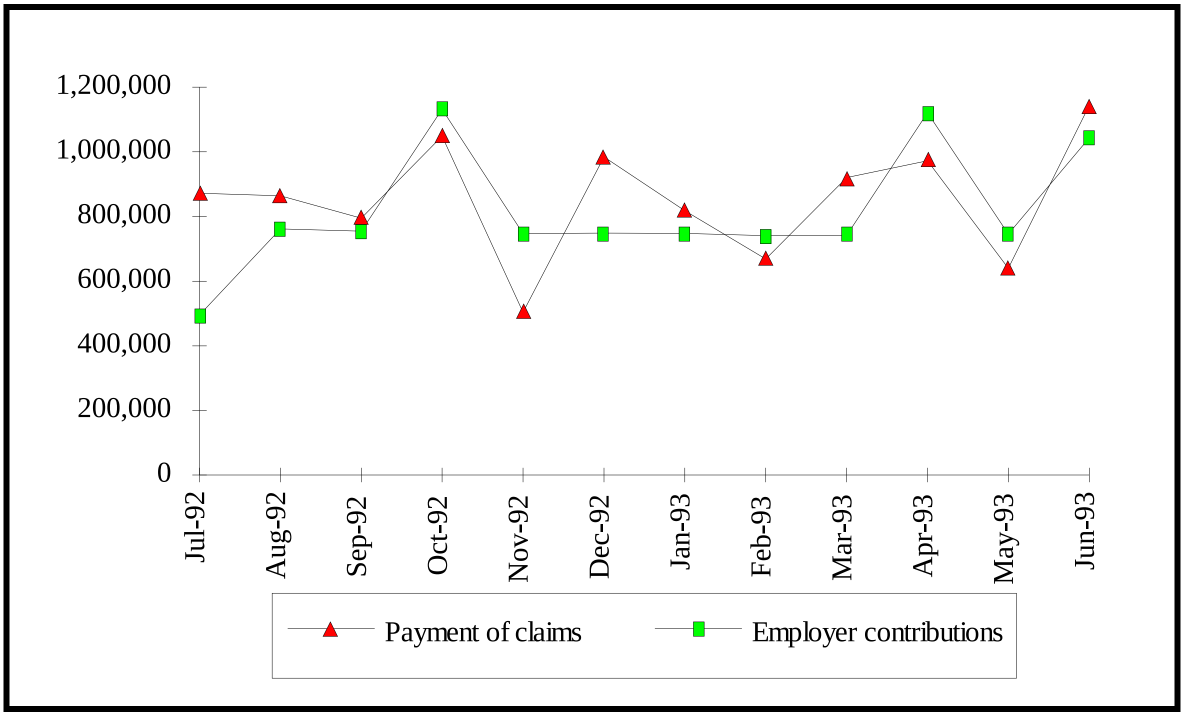
WORKERS' COMPENSATION FUND ACTIVITY
FOR 1986-87 THROUGH 1992-93 NET
<u>OF ADJUSTMENTS AND TRANSFERS</u>



In addition, our review revealed that operating revenues and expenditures are distributed fairly evenly throughout the year. For example, payroll contributions are credited to the Fund biweekly, and investment earnings are credited to the Fund monthly. Thus, if payroll rates generate sufficient monthly cash flows to cover expected monthly claims payments and operating expenses, Fund reserves may not be needed at all during a given year. Under this scenario, reserves in the Fund could be safely invested for a longer term. For example, as shown in Graph II, monthly revenues and expenditures matched fairly closely during the last fiscal year.

GRAPH II

1992-93 CLAIMS PAYMENTS VERSUS EMPLOYER CONTRIBUTION
<u>IN THE WORKERS' COMPENSATION FUND</u>



In addition, it should be noted that for the City to fulfill its fully funded policy, the City's workers' compensation payroll rates, like the premiums insured employers pay, should generate sufficient cash flows to cover the City's total incurred liability including any shortfalls in prior estimates. The City has a policy to fully fund the workers' compensation liability. Accordingly, the Finance Department should annually review and recommend to the City Council payroll rates which will generate sufficient funds to effectuate the City's funding policy.

State Compensation Insurance Fund Portfolio

The administrators of the State Compensation Insurance Fund have a long-term investment strategy of investing in U.S. bonds and notes, public utilities, and industrials. Currently, 66 percent of the State Compensation Insurance Fund's $6 billion portfolio is invested in government bonds and notes with maturities of from one to 30 years. The State Compensation Insurance Fund's portfolio is invested about 30 percent each in one-year to five-year, six-year to ten-year, and 11-year to 30-year instruments. As of June 30, 1993, the State Compensation Insurance Fund's portfolio had a weighted average years to maturity of 10.75 years and an effective yield of 6.25 percent. Due to the fact that the State Compensation Insurance Fund began this strategy over 12 years ago, some instruments in its portfolio realize yields as high as 14.5 percent.

As shown in Table II, additional interest earnings of $235,200 per year could be safely realized if the City mimicked the State Compensation Insurance Fund's strategy and invested the Fund's cash reserves in a separate portfolio comprised of instruments with longer maturities. By investing in a portfolio with average maturities of 10 years, the City could safely realize a 5.5 percent rate of return at current yields. It should be noted that the Finance Department is modeling this type of portfolio but estimates that a gradual conversion to longer term instruments is necessary to reduce interest rate risk. As a result, the Finance Department estimates that a 5.5 percent yield may not be achieved for several years.

TABLE II

WORKERS' COMPENSATION FUND INTEREST COMPARISON
FOR SHORT- VERSUS LONG-TERM MATURITIES

Portfolio Structure: **Weighted Average Days To Maturity**	**Current Average Maturities**	**Assumed Average Maturity**
Assumed Amount for Investment	$32,000,000	$32,000,000
Annual Interest Rate of Return on Investments	4.765%	5.5%
Annual Interest Earnings	$1,524,800	$1,760,000
Additional Annual Interest Earnings	$235,200	

In addition, we estimate that an assumed rate of return on investment of 5.5 percent would reduce the Fund's estimated financial statement liability by about $2.1 million. This reduced liability is a function of how the Fund's liability is calculated. Specifically, the assumed interest earnings rate of Fund reserves is an important variable the City uses to calculate the Fund's liability. The higher the Fund's assumed interest earnings rate, the lower the calculated Fund liability. This occurs because Governmental Accounting Standards Board Statement No. 10 (GASB 10) allows reserves which are held for payment of claims to be discounted by the amount of anticipated investment income. In order to calculate the allowance for anticipated investment income, a rate of return must be assumed and the length of time reserves are expected to be held before claims are paid must be determined. Applying the precepts of GASB 10, the Fund's June 30, 1993, financial statement liability would be as follows assuming the Fund earned zero, 4 percent, and 5.5 percent interest on its reserves investments.

Assumed Investment <u>Earnings Rate</u>	**Calculated Financial Statement <u>Liability At June 30, 1993</u>**
-0-	$48,400,000
4%	41,800,000
5.5%	39,700,000

Because the Fund is combined with the other City funds and invested in the City's Pooled Investment Fund, the Administration assumed the Fund's reserves interest earnings to be only 4 percent. This is a reasonable, albeit conservative, assumption given that the Pooled Investment Fund had an investment rate of 4.765 percent as of June 30, 1993. However, as is shown above, an assumed investment rate of 5.5 percent would reduce the Fund's June 30, 1993, financial statement liability from $41,800,000 to $39,700,000--a reduction of $2,100,000.

CONCLUSION

Our review revealed that the Workers' Compensation Fund has cash reserves of about $32 million which theoretically can be invested for an indefinite period of time provided the City's biweekly payroll contributions to the Fund cover ongoing Fund payouts. Our review also revealed that the State Compensation Insurance Fund has its cash reserves invested in instruments with an average maturity that is nearly 10 years longer than the City's with resultant interest earnings that are 31 percent higher. As a result, we estimate that cash reserves can be invested in instruments with longer maturities and safely realize about $235,000 in additional interest earnings per year without jeopardizing the Fund's integrity. In addition, by investing in instruments with longer maturities, the City can reduce its financial statement liability by an estimated $2.1 million.

RECOMMENDATIONS

We recommend that the City Council:

Recommendation #1:

Adopt an investment policy that allows the Administration to separately invest Workers' Compensation Fund reserves in instruments with longer maturities. (Priority 1)

Furthermore, we recommend that the Finance Department:

Recommendation #2:

Annually review and recommend to the City Council workers' compensation payroll rates that will generate sufficient cash flows to the Workers' Compensation Fund to cover expected claims costs, operating expenses, and any additional amounts deemed necessary to effectuate the City's workers' compensation funding policy. (Priority 3)

RECEIVED

DEC 0 2 1993

CITY OF SAN JOSE - MEMORANDUM

TO:	Gerald A. Silva City Auditor	**FROM:**	John Guthrie Director of Finance
SUBJECT:	**RESPONSE TO THE AUDIT OF WORKERS' COMPENSATION PROGRAM**	**DATE:**	December 2, 1993

Approved: [signature] **Date:**

The Finance Department has reviewed the final draft report of an audit of the City's investment of workers' compensation reserves. The department has enjoyed working with your staff on this audit. Although our views have some times differed, we found this project both challenging and enlightening. The Finance Department agrees and supports the recommendations of this report.

In addition to providing the Finance Department with recommendations for improvement, we appreciate that your office acknowledged the measures taken by the Finance Department which have and will improve this City operation.

Recommendation #1 (Priority 1):

Adopt an investment policy that allows the Administration to separately invest Workers' Compensation Fund reserves in instruments with longer maturities.

Response:

The Finance Department concurs with this recommendation and previously discussed the concept of a separate investment policy and portfolio for the Workers' Compensation Fund reserves with both the Finance Committee and Internal Investment Committee during FY 92-93. During the past several months Finance staff have continued researching and modelling appropriate investment policy considerations (eg. maximum allowable maturity, average maturity, alternative methods of establishing a segregated portfolio, etc.) for these reserves in preparation for a report to the Finance Committee in early December 1993. Based on this research, the Department recommends a maximum maturity of 10 years and average maturity of 5 to 8 years rather than the 10 year average maturity recommended by the City Auditor. Equally important is the strategy for a gradual phase in over a four year period. The reasons for these recommendations are discussed in the Finance staff report dated December 2, 1993 (Finance Committee Agenda Item #5, December 8, 1993).

Recommendation #2 (Priority 3):

Annually review and recommend to the City Council workers' compensation payroll rates that will generate sufficient cash flows to the Workers' Compensation Fund to cover expected claims costs, operating expenses, and any additional amounts deemed necessary to effectuate the City's workers' compensation funding.

Response:

We support and agree with this recommendation.

John V. Guthrie
Director of Finance

APPENDIX A

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Policy Manual (6.1.2) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class[1]	**Description**	**Implementation Category**	**Implementation Action**[3]
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.[2]	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists.[2]	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

1 The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. **(CAM 196.4)**

2 For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of $25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of $50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens.
(CAM 196.4)

3 The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.
(CAM 196.4)

APPENDIX B

CITY OF SAN JOSE - MEMORANDUM

TO: *Gerald A. Silva*
City Auditor

FROM: *John V. Guthrie*
Director Of Finance

SUBJECT: ***WORKERS' COMPENSATION AUDIT***

DATE: *October 22, 1993*

Approved:

Date:

This memorandum is in response to your request of October 21, 1993, to provide a summary of any major accomplishments relative to the Workers' Compensation Program: We present the following accomplishments in accordance with this request:

- *A claims management database was implemented in June, 1991.*
- *Achieved salary savings in claims administration through the elimination of all contract employees as of October, 1991.*
- *Claims computer data has been enhanced and corrected through several major efforts.*
- *Reserving policy/guidelines revised and implemented with the staff.*
- *Increasing efforts in the safety education process by developing training programs customized to reduce specific injury trends.*
- *Developed a recognition process for department managers who encourage safety activities and get results.*
- *Implemented the cost containment program in October, 1993 which includes three components:*
    - *medical bill review*
    - *utilization review*
    - *preferred provider organization*

RECEIVED
NOV 0 1 1993
CITY AUDITOR

- *Evaluating the use of an individual portfolio of investment funds for the Workers' Compensation Fund.*
- *Provided key input to the City's Legislative Analyst regarding 1993 Workers' Compensation Reform.*
- *Reduced Claim Adjuster workload by authorizing Claim Assistants the authority to approve medical bills up to $10,000.*
- *Release of semi-annual management reports to departments.*
- *Coordinated Disability Claims Task Force to redirect the manner in which Workers' Compensation is approached in the City.*

John V. Guthrie
Director of Finance