

SPOTLIGHT

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Division

RISK MANAGEMENT DIVISION
OFFICE OF FINANCIAL MANAGEMENT

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DOR'S INTERNAL AUDIT -
AN "ERM" CHAMPION AND PARTNER

As reported in previous Spotlight articles, enterprise risk management (ERM) roots are solidly planted in finance. When ERM sprouted in insurance and risk management circles several years ago, its principles and practices were embraced immediately, quickly generating action to levels achieved through a slower, more calculated growth in the finance world. Application may vary slightly, but ERM's holistic, strategically focused approach to managing risk remains the common bond between the professional audit and risk management worlds.

To learn more about this connection, we recently visited Department of Revenue (DOR) internal auditor manager Karin Hendrickson, CPA, CFE and her staff Todd Larson, CIA, CISA, CISSP, information systems audit manager, and, Christie Hazlett, operations

and financial audit manager. Ms. Hendrickson and her team enthusiastically recounted their efforts to integrate ERM into the internal audit program at DOR, while supporting the Department's Strategic Business Plan Initiative to implement ERM agency-wide.

The Internal Audit profession has seen significant change in expectations, roles and responsibilities in the recent past. Through the 1980s and 1990s, audit standards focused on basic accountability, ethics, and business standards, with little notoriety outside of professional auditing circles. In 1993, the State of Washington enacted RCW 43.88, requiring each state agency to have an internal audit function---a change geared at building independent accountability in state government.

In the early 2000s the "Enron scandal" focused a nationally glaring spotlight on the financial accountancy world. It involved failure of a multi-million dollar company (Enron) with a reported financial condition that was sustained by accounting fraud. The headline grabbing



Karin Hendrickson (center) meets with Todd Larson and Christie Hazlett.

details and consequences of these actions reverberated throughout the business and finance world, eventually resulting in the dissolution of the Arthur Anderson audit firm. Enron, WorldCom and other high profile business failures with links to accountancy fraud eventually lead to legislation passed in July 2002. The Sarbanes-Oxley Act, commonly called "SOX", legislatively addressed corporate fraud. It brought public company accounting and disclosure reform to improve investor confidence and protections.

Born out of Enron and "SOX", 2004 brought significant changes to the *International Standards for the Professional Practice of Internal Auditing*. These standards guide the conduct of internal auditing at both the organizational and individual auditor levels. They are the result of careful study, consultation, and deliberation about the basic principles for providing internal audit services. Members of the Institute of Internal Auditors (IIA) and Certified Internal Auditors (CIA) vow that they will comply with the IIA's Code of Ethics, which requires adherence to the *Standards*.

At the same time ERM-based principles and practices were being refined in professional auditing standards, they were also quickly gaining solid ground as risk management protocol. In December 2005, Ms. Hendrickson attended the Risk Management Division's first executive risk management summit, "Shifting the Odds: Effective Risk Management", held in Lacey. She found its focused ERM message made sense. "I saw that as a state we were headed in this direction, and realized that my challenge was to help our executive managers move it forward in the agency," said Ms. Hendrickson.

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(cont. on page 2)

Commercial Insurance
Update

Additional Insured Status

The term **additional insured** is not specifically defined in most insurance policies, but is generally regarded as an entity that is added to and protected by the terms of an insurance policy.

Here is what your agency should know if it is named as an additional insured on a liability insurance policy the contractor buys. The insurer's responsibilities include the following:

- Must provide a defense if your agency is named in suit
- Must pay your agency's defense costs along with providing liability insurance
- Cannot dismiss its obligations to your agency or a third party claimant due to bankruptcy of the **named insured** (contractor)
- Cannot subrogate against your agency, even if it is legally liable for the loss
- Will most likely include coverage for **personal injury** losses under general liability

Find more information about "additional insured" in the Risk Management Division contracts manual "Contracts: Transferring and Financing Risk" at <http://www.ofm.wa.gov/rmd/risk/riskcont.doc>





CLAIMS

CORNER

STATE EMPLOYEES' PERSONAL PROPERTY LOSS

Agencies frequently contact the Risk Management Division (RMD) with questions about state employee personal property loss or damage. For example, an agency inquired about tort claim status regarding clothes and articles in luggage stolen from a state employee's privately owned vehicle (POV) used for official state business, and parked in a restaurant parking lot while the employee was on lunch break.

"This question can be answered best by one of our standard letters, as it's a question asked fairly often," said Brian Agar, senior investigator for the Risk Management Division. That letter states:

"Our investigation has determined your claim involves a crime of [theft], rather than negligence on behalf of the State. The State of Washington is self-insured for some claims that involve damage or loss of personal property, physical injury, and some other forms of articulable and measurable harm. However, the State of Washington can only pay claims when the asserted harm was a direct result of negligence or tortious conduct on the part of the State."

Negligence is defined by Barron's Dictionary of Insurance Terms as "failure to act with the legally required degree of care of others, resulting in harm to them".

"There are always exceptions, so all claims are reviewed on an individual basis," said Mr. Agar. He also pointed out if the same scenario as above involved a state vehicle instead of a POV, the answer would remain the same. "A theft is a theft... is a theft," said Mr. Agar.

Agencies with questions are always welcome to contact RMD's claims staff for information and guidance on tort claims.

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DOR's INTERNAL AUDIT AN "ERM" CHAMPION AND PARTNER (cont. from page 1)

DOR is maturing its ERM approach, which has benefited from a strong partnership between internal audit and the agency's risk manager, Denise McKay, in leading the agency-wide ERM implementation. "It's important that we all use the same language and have a united ERM front on where we are today and where we want to be in the future", said Ms. Hendrickson.

"An effective, professional internal audit activity can provide management meaningful insights, and assurance on all areas of risk, internal controls, and governance. After all, when used to its best potential, that's what internal auditing is supposed to do", said Ms. Hendrickson, quoting from professional auditing standard resources.

The quality emphasis that is integrated into the newest auditing standards is getting results. DOR's internal audit program recently received high marks in its required a five-year quality review, and the agency received its 15th consecutive year "clean audit" report from the State Auditor's Office. Recent years have seen an increase in requests for services and mentoring from the internal audit section. "They want the discipline and tools we can provide," said Ms. Hendrickson.

"It's important that we all use the same language and have a united ERM front on where we are today and where we want to be in the future."

At the same time, there is more outreach occurring in internal audit professional organizations to cultivate ERM at organizational and strategic levels. This shift has created a recognized need to increase the audit professional's skills and competencies. For instance, skills that enhance working relationships and communication are deemed as critical to quality, ERM-based internal auditing as traditional finance-based skills. The value of internal auditing is increased when applied with top notch interpersonal and communication practices. "Our role is not as prescriptive as it once was. It's about making good decisions and constantly asking--what is going to keep us from accomplishing our goals," said Ms. Hendrickson.

Ms. Hendrickson's recent 2007 Governor's Award for Distinguished Leadership in Management is evidence of the enthusiasm she throws behind ERM and cultivates with her internal audit team. "Solving things together, creating win-win situations, seeing the lights come on" said Mr. Larson, describes the ERM-enhanced approach DOR applies to internal auditing. "It's a new day in internal audit-- really dynamic," added Ms. Hendrickson.



Fast Fact



Did You Know....

Executive Order 05-01, **Establishing Sustainability and Efficiency Goals for State Operations**, addresses sustainability requirements in a number of areas including fleet management. Portions of the executive order addressing fleet management is provided below. See the entire executive order at http://www.governor.wa.gov/execorders/eoarchive/eo_05-01.pdf.

- Agencies with **fewer than 100 light duty vehicles** or without professional fleet management (dedicated staff to handle fleet assets and dedicated fleet information system) shall—
 - Arrange to transfer agency vehicles to the GA Motor Pool (then lease back *OR*)
 - Contract with GA for management of their vehicles while still retaining ownership.
- Agencies with **over 100 light duty vehicles AND that have professional fleet management** shall include a fleet management plan with their Sustainability Plan each even numbered year with the following:
 - Vehicle replacement plan with identified funding.
 - Plan to replace all pre-1996 light duty vehicles by January 2008
 - Annual goals for the percentage of fuel efficient/low emission vehicles in agency fleets.
- Shall report annually on their progress in implementing the Fleet Management Plan to OFM (progress reports due each October 15) *OR*
- Arrange to transfer agency vehicles to the GA Motor Pool (then lease them back)

For questions or more information, contact State Motor Pool Manager **Bryan Bazard** at 360-438-8237 or bbazard@ga.wa.gov or Customer Account Manager **Connie Riker** 360-438-8246 or criker@ga.wa.gov.



RMD STAFF FOCUS



Shannon Stuber, Program Administrator for the Local Government Self-Insurance (LGS) Program joined the Risk Management Division in September, 2007. Not many state agency risk managers will have the opportunity to meet her. But, she is well known to local government managers due to her RMD role with the Local Government Self-Insurance Program (read more in the article to the right).

Ms. Stuber travels extensively throughout the state conducting regulatory examinations and consulting with the various Boards and Administrators of joint self-insurance programs. She especially enjoys meeting elected officials and working with advisory boards involved in the LGS program. Prior to joining OFM, Shannon was an assistant audit manager and insurance field specialist at the State Auditor's Office.

Shannon has three grown daughters, Erin, Emily and Sara. Husband, Don is a long time DOT employee. She enjoys playing and singing music. She also has an interest in straw bale and other green building techniques.

RMD's Local Government Self-Insurance Program Connection

The Local Government Self-Insurance Program (LGS) provides oversight through continuous monitoring and periodic onsite examinations of self-insurance programs throughout the state. These local governments include cities, counties, special districts and, in some cases, non-profits that jointly or individually self-insure.



Coverage for the local government insurance programs may include:

- property insurance for buildings, autos and other assets owned by the governments (in addition to)
- liability insurance for elected and appointed officials, management and employees
- health and welfare (medical insurance) coverage

The programs set aside a reserve, or pool of monies to pay deductibles. This is considered to be the "self-insurance deductible" (SIR) layer. Above this layer, programs may purchase a standard insurance policy (called excess or reinsurance), which protects against losses that exceed the self-insurance layer. Typically, the programs choose to accept as much risk as financially feasible, which means the deductibles paid per claim could be large. The ability to self-insure and accept risk for larger deductibles paid from the SIR reduces the cost of the excess insurance policy.

Through effective risk management practices, the programs reduce losses paid from the SIR, which may allow them to retain and invest pooled funds not paid in claims. These funds earn interest and provide a "cushion" for the programs, as the cost of excess insurance is subject to market volatility and may vary from year to year. Should the cost of insurance increase substantially during a "hard" insurance market, this cushion may be used to reduce the cost of premiums and prevent unanticipated increases. Because they rely on stable budgets and have finite taxpayer resources, local governments depend on the programs to keep the cost of insurance stable. The ability to anticipate insurance expenses and control cost overruns is of primary concern to local governments and the citizens who provide these funds.

Local government self-insurance programs are given maximum flexibility in their design and operation by enabling legislation (RCW 48.62). Each local government has insurance needs that may be unique to their location or function. Through monitoring and on-site examinations, the LGS team ensures that self-insurance programs funded with local taxpayer dollars comply with laws and regulations and are financially sound, while still having the flexibility to tailor insurance coverage and services as needed.

LEGAL LINKS



Evidence Preservation Procedure Must be Enterprise-Wide

An agency's evidence preservation procedure should be an agency-wide business initiative, which is fully supported by agency management. The agency should have a system for-

- ⊕ identifying, reporting, and deciding when to initiate a preservation effort
- ⊕ process for identifying all agency employees having potential evidence

Disclaimer: This is not legal advice and should not be used as legal advice. It is merely a general educational item that may be of use to risk management efforts within state agencies.

