

Audit Report

Maryland Automobile Insurance Fund

November 2009



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

-
- This report and any related follow-up correspondence are available to the public through the Office of Legislative Audits at 301 West Preston Street, Room 1202, Baltimore, Maryland 21201. The Office may be contacted by telephone at 410-946-5900, 301-970-5900, or 1-877-486-9964.
 - Electronic copies of our audit reports can be viewed or downloaded from our website at <http://www.ola.state.md.us>.
 - Alternate formats may be requested through the Maryland Relay Service at 1-800-735-2258.
 - The Department of Legislative Services – Office of the Executive Director, 90 State Circle, Annapolis, Maryland 21401 can also assist you in obtaining copies of our reports and related correspondence. The Department may be contacted by telephone at 410-946-5400 or 301-970-5400.
-



DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

November 4, 2009

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Maryland Automobile Insurance Fund (MAIF) for the period beginning December 13, 2005 and ending March 3, 2009. MAIF's primary responsibilities are to provide automobile insurance policies for those residents of Maryland whose applications have been declined by private insurers and to administer and pay claims to residents of Maryland who are involved in accidents in Maryland with motorists who are uninsured.

Our audit disclosed that, in June and December of 2008, MAIF's Board of Trustees approved changes to certain critical requirements of MAIF's calendar year 2008 employee bonus program. We question the timing and appropriateness of these changes, without which the majority of that year's approximately \$1.4 million in bonuses would not have been paid. We also noted certain expenditures for consulting, marketing, and lobbying services, as well as certain outreach costs, that may not be consistent with MAIF's primary mission as a State-created insurer of last resort. Due to their nature, we believe certain expenditures should be subject to disclosure to the legislature's budget committees to ensure that such expenditures are consistent with the legislature's intended mission for MAIF.

Our audit also disclosed that certain procurement transactions were not consistent with MAIF's established procurement procedures and that documentation of expenditures could be improved. Finally, we noted that payments made to private attorneys were not always reported in accordance with regulations of the Internal Revenue Service.

MAIF'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 MAIF.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

Table of Contents

Background Information	4
Agency Responsibilities	4
Analysis Conducted by the Maryland Insurance Administration	4
Financial Statement Audits	4
Status of Findings From Preceding Audit Report	5
Findings and Recommendations	6
Employee Bonuses	
Finding 1 (Policy Issue) – During Calendar Year 2008, Changes Were Made to Critical Provisions of MAIF’s Employee Bonus Program, without Which the Majority of the \$1.4 Million in Bonuses Paid for the Year Would Not Have Been Paid	6
Disclosure of Certain Expenditures to Budget Committees	
Finding 2 (Policy Issue) – Certain Expenditures Should Be Disclosed to the Legislative Budget Committees as Part of the Annual Budget Submission Process	7
Procurements and Disbursements	
Finding 3 – Certain Procurement Transactions Were Not Consistent with MAIF’s Established Procedures	9
Finding 4 – Sufficient Documentation to Support Expenditures Was Not Always on File or Properly Reviewed	10
Attorney Payments	
Finding 5 – Certain Payments to Plaintiff Attorneys Were Not Reported in Accordance with Internal Revenue Service Regulations	11
Audit Scope, Objectives, and Methodology	12
Agency Response	Appendix

Background Information

Agency Responsibilities

The Maryland Automobile Insurance Fund (MAIF), which consists of an Insured and an Uninsured Division, operates under the provisions of Title 20 of the Insurance Article of the Annotated Code of Maryland. The Insured Division's purpose is to provide automobile liability and property damage insurance coverage on personal vehicles and, to a lesser extent, commercial vehicles to Maryland residents who are unable to obtain coverage from private insurance carriers. The Uninsured Division is responsible for paying claims to eligible victims of traffic accidents caused by operators of uninsured or unidentified vehicles provided that the victim does not have recourse through an insurance policy which would cover any related loss. According to its records, during calendar year 2008, MAIF processed and issued claims payments that totaled approximately \$108 million. In addition, total MAIF operating expenditures were approximately \$50.6 million during that period.

Analysis Conducted by the Maryland Insurance Administration

State law stipulates certain eligibility requirements for individuals applying for insurance coverage from MAIF. These include a requirement that an applicant has attempted in good faith to obtain automobile liability insurance required by law from at least two other insurers, but has been rejected or refused a policy for any reason other than nonpayment of premiums. An applicant may also have had their policy with another insurer canceled or not renewed for any reason other than nonpayment of premiums. We were advised by Maryland Insurance Administration management personnel that the Administration recently conducted an analysis of the requirement for an applicant to have been rejected by two insurers as a prerequisite for obtaining coverage from MAIF. We were also advised that this analysis covered the period June 1, 2005 to May 31, 2009, and that, as of October 14, 2009, the results of the analysis had not yet been finalized.

Financial Statement Audits

MAIF engaged an independent accounting firm to audit the statutory-basis financial statements of the Insured Division. In the related audit reports for calendar years 2006, 2007, and 2008, the firm stated that the financial statements presented fairly, in all material respects, the financial position of the Insured Division, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the Maryland Insurance Administration.

In addition, MAIF engaged the same accounting firm to audit the financial statements of the Uninsured Division for the calendar years 2006, 2007, and 2008. In the related audit reports, the firm stated that the financial statements presented fairly, in all material respects, the financial position, results of operations and cash flows of the Uninsured Division for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the three findings contained in our preceding audit report dated October 25, 2006. We determined that MAIF satisfactorily addressed these findings.

Findings and Recommendations

Employee Bonuses

Finding 1 (Policy Issue)

During calendar year 2008, changes were made to critical provisions of the Maryland Automobile Insurance Fund's employee bonus program, without which the majority of the \$1.4 million in bonuses paid for the year would not have been paid.

Analysis

During calendar year 2008, the Maryland Automobile Insurance Fund's (MAIF) Board of Trustees approved changes to certain critical requirements of MAIF's Gain Sharing Program (bonus program) that allowed for the payment of employee bonuses for this year totaling approximately \$1.4 million, the majority of which would not have been paid without those changes.

Specifically, in June 2008, the Board revised the financial goal, which served as the basis for 75 percent of the calendar year 2008 bonuses paid to non-management employees. The goal was based on certain financial results experienced by MAIF for the year, such as premiums earned and expenses incurred. By making this change, bonuses could be awarded for lower financial results, such as lower premium income, higher claim losses or expenses, or combinations thereof. Bonuses paid to non-management employees totaled approximately \$1 million for calendar year 2008. If the change to the goal had not been made, employees would only have been entitled to bonuses of approximately \$250,000 based on certain non-financial performance results.

Similarly, in December 2008, the Board essentially waived the program's previously existing requirement that MAIF have an annual net income gain (that is, a profit) for calendar year 2008 before bonuses could be paid to approximately 30 management and executive employees. At the time of the Board's decision, it was anticipated that MAIF would end calendar year 2008 with a net loss and, according to MAIF's audited financial statements for the year, MAIF did have a net loss of approximately \$19.6 million. Although the Board reduced the bonus amounts from what employees would have received if a net income gain had occurred, payments to these employees still totaled approximately \$407,000¹.

¹ For example, certain bonuses were reduced from 15 to 11.25 percent and others were reduced from 20 to 13.25 percent of annual salaries.

Regarding these changes, MAIF's management personnel advised the Board that the change to the goal for non-management employees was necessary because certain current economic trends were competing and undercutting the appropriateness of that goal as it then stood. For example, management stated that current attempts to maintain low insurance rates may aid in MAIF's efforts to keep motorists insured, but may also have a negative effect on this financial goal. In addition, management noted that MAIF's net loss for the year was not the result of underperformance on the part of management employees, but the result of "deliberate decision making on the part of management in response to radically altered corporate imperatives" as well as the effects of the worldwide financial crisis (recession).

According to State law, the Executive Director has the authority to set employee compensation with the approval of the Board of Trustees. Furthermore, the Board retains the prerogative to amend the goals and all aspects of the bonus program whenever it decides that circumstances warrant such change. However, we question whether such significant changes to critical program requirements were appropriate since the changes occurred during the applicable year, after it had become apparent that the original requirements would not be met, and especially in light of the size of the net loss (\$19.6 million) incurred by MAIF and the financial stress being experienced by the State as a whole.

Recommendation 1

We recommend that the Board of Trustees not significantly revise or waive critical requirements of the bonus program to allow for the payment of bonuses after the requirements have been approved and the applicable year has begun.

Disclosure of Certain Expenditures to Budget Committees

Finding 2 (Policy Issue)

Disclosure of certain expenditures should be made as part of the annual budget submission to legislative committees.

Analysis

During our audit period, we noted certain expenditures which appeared to be inconsistent with the mission of a State-created entity designated as an insurer of last resort. Specifically, these expenditures appeared to be more indicative of a private insurer which, as authorized under State law, is a role that MAIF also performs in certain circumstances. These dual roles create some ambiguity with respect to MAIF's activities and the appropriateness of the aforementioned

expenditures. Specifically, according to the Insurance Article of the Annotated Code of Maryland, the purpose of MAIF is to provide automobile insurance to eligible Maryland residents who are unable to obtain insurance in the private market. However, this Article also entitles a MAIF policyholder, after three continuous years of MAIF coverage and meeting certain requirements², to continuation of coverage from MAIF at rates that are reasonably comparable to those charged by standard insurers. This effectively puts a segment of MAIF's business relating to certain preexisting customers in competition with other insurers. Consequently, we believe that, due to their nature, certain expenditures should be subject to disclosure to the legislative budget committees to ensure the expenditures are consistent with the legislature's intended mission for MAIF and the nature of MAIF's business.

For example, during calendar years 2008 and 2009 (through May 31), we noted that expenditures included approximately \$96,000 for strategic consulting services; \$81,000 for marketing, public relations, and advertising; and \$74,000 for lobbying services. In addition, we noted expenditures for producer (agent) appreciation events, such as \$15,000 for catering and space rental, and at least \$9,000 for corporate sponsorships. MAIF is a non-budgeted fund agency (and, as such, does not receive any State general funds) that currently submits its budget to the General Assembly for informational purposes only. Those budgets do not include the type of detailed expenditure data noted here.

The law does not prohibit these expenditures, and MAIF management considers such expenditures necessary to help MAIF successfully fulfill its mission. Specifically, management has advised that it considers MAIF a business, albeit one created by the State, and that it is appropriate and necessary to incur certain expenditures to promote MAIF within the public and business community, and to promote certain MAIF initiatives within the legislature. Management believes that these expenditures are in keeping with efforts to help ensure that all motorists in the State are insured, and to help control costs for all Maryland motorists. However, management also agrees that certain provisions of the law, as now written, effectively ensure that MAIF will not go out of business regardless of its financial results.

We recognize the unique position of MAIF in relation to State government, and that the law has provided latitude to MAIF management in performing MAIF operations. However, MAIF is ultimately accountable to the State of Maryland.

² For example, having not been charged with a moving traffic violation and assessed more than one point by the Maryland Motor Vehicle Administration.

Therefore, we believe that it should disclose more detailed expenditure data to the legislature, including the aforementioned items, to ensure that these transactions are in accordance with the intended purpose of MAIF.

Recommendation 2

We recommend that MAIF report the detailed budget and expenditure data for consulting and lobbying services, marketing and public relations costs, as well as expenditures for producer related events, corporate sponsorships, and other similar outreach costs, to the legislative budget committees.

Procurements and Disbursements

Finding 3

Certain procurement transactions processed by MAIF were not consistent with its *Procurement Procedures Manual*.

Analysis

Certain procurement transactions processed by MAIF were not consistent with its *Procurement Procedures Manual*. Specifically, we examined eight service agreements with purchase orders issued totaling approximately \$1.9 million. Our review disclosed that written documentation justifying the use of the sole source procurement method was not on file, as required, for three contracts that, according to MAIF personnel, were procured in this manner. Expenditures for these contracts, which were for certain consulting and marketing services, totaled approximately \$287,000 for the period from January 1, 2007 to May 31, 2009. In addition, MAIF did not have a written contract on file for certain maintenance services, which MAIF had been receiving for approximately 11 years. Payments to this vendor in calendar year 2008 totaled approximately \$20,000.

MAIF's *Procurement Procedures Manual* requires written justification for sole source procurements. Furthermore, the *Manual* provides for written contracts establishing specific deliverables and terms for ongoing services.

Recommendation 3

We recommend that MAIF

- a. maintain documentation justifying use of the sole source procurement method, and**
- b. ensure written contracts are established with all vendors providing ongoing services.**

Finding 4

Documentation sufficient to support expenditures was not always on file, or was not always reviewed by personnel responsible for processing expenditures.

Analysis

Sufficient documentation was not always obtained to support credit card expenditures incurred, and vendor documentation that was obtained for other MAIF expenditures was not always reviewed by those employees responsible for processing these transactions.

- Our review of 61 credit card expenditures totaling approximately \$17,300, incurred during six months in calendar year 2008, disclosed 51 expenditures totaling approximately \$14,100 for which detailed supporting receipts were not on file. In the absence of a detailed receipt, MAIF used the applicable credit card statement as support for the expenditure. These expenditures included, for example, two restaurant billings totaling approximately \$4,000. Credit card expenditures totaled \$173,000 in calendar year 2008.
- Our review of 23 other MAIF expenditures totaling approximately \$115,000 disclosed 8 expenditures totaling \$22,000, which were processed by MAIF's fiscal unit without reviewing the related vendor invoice. Although we verified that the invoices had been obtained by MAIF for these expenditures, which included catering and hotel billings, the approved invoices were not submitted to the fiscal unit. Rather, the fiscal unit instead relied on a memo submitted by authorized personnel requesting payment.

MAIF's *Expense Account Rules and Regulations* generally require adequate receipts to support such expenditures. Although other documentation may be used in certain circumstances, credit card statements do not provide sufficient detail to properly evaluate the propriety of such expenditures. In addition, controls over expenditures should allow fiscal personnel to obtain reasonable assurance that expenditures were proper before payment.

Recommendation 4

We recommend that

- MAIF require detailed receipts to support credit card expenditures, and**
- fiscal personnel responsible for processing expenditures examine approved vendor invoices to help verify the accuracy and propriety of those expenditures.**

Attorney Payments

Finding 5

Certain payments made to plaintiff attorneys were not reported in accordance with Internal Revenue Service regulations.

Analysis

Certain payments made to plaintiff attorneys were not reported in accordance with regulations of the Internal Revenue Service (IRS). Those regulations require payers to use IRS Form 1099 to report payments to attorneys, including payments made for the benefit of the attorney's client. However, our test of five such payments made by the Uninsured Division during calendar year 2008 totaling approximately \$100,000 disclosed that the required Form 1099 had not been issued for any of the payments.

We were advised that this occurred because complete vendor coding information had not been recorded in the automated claims records for these payments. Consequently, a corresponding Form 1099 had not been generated. Our review of the Division's automated records for attorney payments during calendar year 2008 disclosed payments totaling approximately \$560,000 for which there was a similar lack of complete vendor coding information. Consequently other payments, in addition to the five mentioned above, may not have been properly reported. Attorney payments by the Division totaled \$1.3 million for the year.

Recommendation 5

We recommend that MAIF

- a. ensure that vendor coding information is properly recorded and that all applicable payments to plaintiff attorneys are reported as required by IRS regulations; and**
- b. determine if previous payments not reported on Form 1099, such as those noted in our test work, need to be reported and, if so, report these previous payments to the IRS.**

Audit Scope, Objectives, and Methodology

We have audited the Maryland Automobile Fund (MAIF) for the period beginning December 13, 2005 and ending March 3, 2009. 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 the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine MAIF's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. The areas addressed by the audit included claims processing, cash receipts, procurements and disbursements, and accounts receivable. We also determined the status of the findings contained 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. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of MAIF's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

MAIF'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 a finding relating to a condition that we consider to be significant deficiency in the design or operation of internal control that could adversely affect MAIF'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 MAIF that did not warrant inclusion in this report.

MAIF'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 MAIF regarding the results of our review of its response.

APPENDIX



Maryland Automobile Insurance Fund

Executive Department
1750 Forest Drive
Annapolis, MD 21401-4294
410.269.8609 Phone
410.269.4344 Fax

October 29, 2009

Bruce A. Myers, CPA
Legislative Auditor
State of Maryland
Office of Legislative Audits
State Office Building, Room 1202
301 West Preston Street
Baltimore, Maryland 21201

Dear Mr. Myers:

We wish to commend your office for the high level of professionalism with which it conducted its most recent audit of the Maryland Automobile Insurance Fund. We are enormously gratified by two points. First, no comments were repeated from the October 25, 2006 audit, indicating that MAIF has assertively addressed the points therein. Second, it is also heartening to know that despite our handling of hundreds of millions of dollars of insurance transactions in a very challenging environment, your audit found no instances of fraud or abuse.

With respect to Finding 1, we note that this is labeled a policy issue, and that you acknowledge that the Board's actions were completely within its discretion, and that no law, regulation, or procedure was violated. With respect to the policy issue you raised, the MAIF Board reasonably considered the factors that made its originally established goals unattainable (namely the effort to keep premiums as affordable as possible despite business volume declines and the most catastrophic economic downturn in 75 years) and determined to exercise an element of fairness for the benefit of MAIF employees. As you note, state law requires the Executive Director and the Board to set employee compensation levels and "the Board retains the prerogative to amend the goals and all aspects of the bonus program whenever it decides that circumstances warrant such change." It is hard to imagine a set of circumstances which more warranted an adjustment to MAIF's incentive program than the ones it confronted in 2008. As is the case with virtually all board-governed enterprises, it is reasonable and prudent for the Board to retain the prerogative to adjust incentive goals, up or down, as needed.

Regarding Finding 2, which you also labeled a policy issue, MAIF always has and will continue to comply with State law, as well as regulatory and legislative requests, regarding its budget and expenditures. We note that certain items identified in your audit have specifically been disclosed. Lobbying expenses, for example, are delineated in MAIF's Annual Report filed with the Maryland Insurance Administration. These, in addition to producer related expenses, have been furnished to the Senate Finance Committee in the past. We will continue to work with the budget committees to make sure each continues to receive all the information.


Bruce A. Myers, CPA, Legislator Auditor
October 29, 2009
Page 2

On Finding 3, as we discussed during our exit interview, MAIF has already implemented a refined set of controls to ascertain that appropriate documentation, including contracts and sole source justifications, is maintained for its procurements. We agree with Recommendation 3.

On Finding 4, the controls mentioned above apply to all MAIF expenditures. As a point of perspective, however, the expenditures noted in your audit represent .0007% of MAIF's 2008 budget. MAIF accepted the recommendation and implemented the necessary changes.

On Finding 5, relating to MAIF's Uninsured Division, we agree. MAIF has already reiterated the procedures to the involved personnel, and corrected all 2009 entries. MAIF will make the requested review of whether prior years need to be corrected.

Sincerely,


M. Kent Krabbe
Executive Director


James Rowland
Chair, Board of Trustees

AUDIT TEAM

Paul R. Denz, CPA

Audit Manager

W. Thomas Sides

Senior Auditor

Jean M. Cubello

Michael J. Murdzak

Staff Auditors