

STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA



NORTH CAROLINA INDUSTRIAL COMMISSION

WORKERS' COMPENSATION PROGRAM

PERFORMANCE AUDIT
NOVEMBER 2016



NC OSA
The Taxpayers' Watchdog

EXECUTIVE SUMMARY

PURPOSE

This audit determines whether the North Carolina Industrial Commission (Commission) effectively ensures compliance with the North Carolina Workers' Compensation Act (Act).

BACKGROUND

The Workers' Compensation Act requires companies in North Carolina to carry workers' compensation coverage unless exempt. The Act ensures that an employee or an employee's family will receive workers' compensation benefits if the worker is injured or dies on the job.

A 2012 newspaper article estimated that there were approximately 30,000 businesses operating in North Carolina without workers' compensation coverage.

In 2013, the Office of the State Auditor reported that the Commission lacked the complete, accurate, and reliable data necessary to proactively identify all businesses without workers' compensation insurance.

Since the 2013 audit, the Commission reported that it has made several improvements to its process. The Commission reported that it used a software tool to proactively identify businesses that dropped or had a lapse in coverage. The Commission stated that the software helped bring more than 1,300 businesses into compliance and increased penalty collections.

KEY FINDINGS

- All noncompliant businesses still not identified, resulting in financial difficulties for injured workers
- Investigative process not completed timely, making recovery of medical costs and lost wages more difficult for injured workers
- Inadequate oversight of investigation and penalty cancellation process increases opportunity for noncompliance

KEY RECOMMENDATIONS

- The Commission should continue to work with the Government Data Analytics Center to obtain complete, accurate, timely data necessary to perform data matching and identify noncompliant businesses that have never carried the required insurance
- The Commission should set clear, specific goals that are linked to and measured by performance measures so that decision-makers can evaluate the Commission's performance
- The Commission should design and/or put into effect policies and procedures to provide reasonable assurance that transactions processed by the staff are complete, accurate, and valid and that regulatory objectives are met

The key findings and recommendations in this summary may not be inclusive of all the findings and recommendations in this report.

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Office of the State Auditor



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AUDITOR'S TRANSMITTAL

The Honorable Pat McCrory, Governor
Members of the North Carolina General Assembly
Mr. Charlton L. Allen, Chairman of North Carolina Industrial Commission

Ladies and Gentlemen:

We are pleased to submit this performance report titled *Workers' Compensation Program*. The audit objective was to determine whether the North Carolina Industrial Commission took appropriate corrective action to address recommendations made in the *Workers' Compensation Program* audit report issued by the Office of the State Auditor in February 2013.

The audit objective was to determine whether the North Carolina Industrial Commission effectively ensures compliance with the North Carolina Workers' Compensation Act.

The North Carolina Industrial Commission's Chairman, Charlton Allen, reviewed a draft copy of this report. His written comments are included starting on page 12.

This audit was conducted in accordance with Article 5A of Chapter 147 of the North Carolina General Statute.

We appreciate the courtesy and cooperation received from management and the employees of the North Carolina Industrial Commission during our audit.

Respectfully submitted,

A handwritten signature in cursive script that reads 'Beth A. Wood'.

Beth A. Wood, CPA
State Auditor



**Beth A. Wood, CPA
State Auditor**

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Article V, Chapter 147 of the North Carolina General Statutes, gives the Auditor broad powers to examine all books, records, files, papers, documents, and financial affairs of every state agency and any organization that receives public funding. The Auditor also has the power to summon people to produce records and to answer questions under oath.



BACKGROUND

The Workers' Compensation Act (Act)¹ requires companies in North Carolina to carry workers' compensation coverage unless exempt.² Companies can comply by maintaining workers' compensation insurance, self-insuring, or becoming a member of or contributing to a self-insured fund. The Act ensures that an employee or an employee's family will receive workers' compensation benefits if the worker is injured or dies on the job.

The Act also created the North Carolina Industrial Commission (Commission) to track compliance with the prompt payment of compensation and to resolve requests for, or disputes involving, medical compensation. Under the Act, the Commission is charged with identifying noncompliant businesses and assessing penalties for noncompliance.

In 2013, the Office of the State Auditor reported that the Commission lacked the complete, accurate, and reliable data needed to proactively identify noncompliant businesses and had not implemented a system to identify all businesses without workers' compensation insurance. At that time, the Commission generally assessed penalties only when an injury report was received. Since there was no process to proactively identify noncompliant businesses, there were few opportunities to penalize businesses that were noncompliant but had not had an employee injured.

Since the 2013 audit, the Commission reported that it made several improvements to its process. The Commission reported that it used a software tool to proactively identify businesses that dropped or had a lapse in coverage.

Per the Commission, its Noncompliant Employer Targeting System (NETS) database³ analyzes data from the NC Rate Bureau and the Division of Employment Security and proactively identifies businesses and employers who dropped or had lapses in workers' compensation insurance.

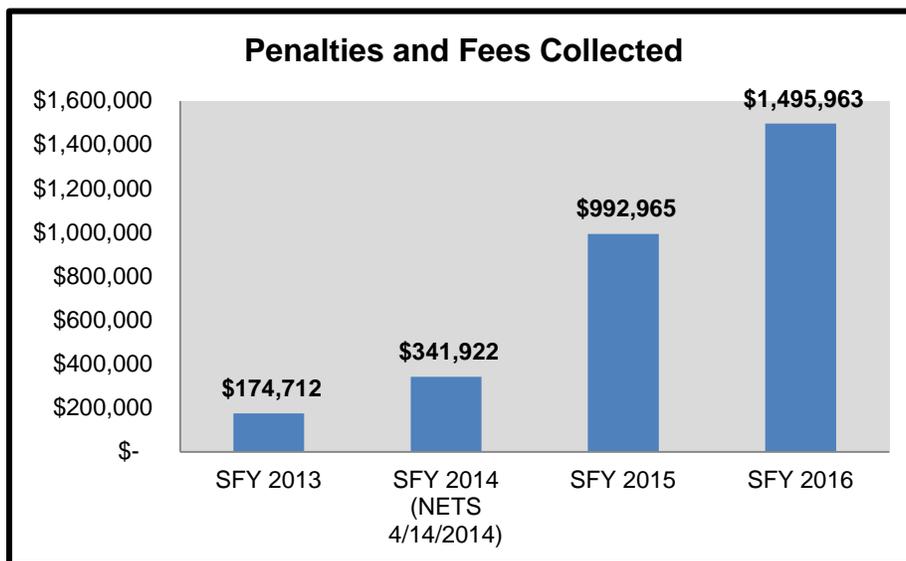
The Commission reported bringing more than 1,300 businesses into compliance and collecting more than \$2.5 million in penalties and fees since the implementation of a new software tool in April 2014.

The table on the next page shows the amounts of penalties and fees collected by the Commission between fiscal years 2013 and 2016.

¹ NCGS §97

² Employers are exempt from the Workers' Compensation Act if they employ fewer than three employees (no exemption applies if activities involve the use or presence of radiation), are in the agriculture or domestic service businesses and employ fewer than 10 employees, or operate a sawmill or logging company with fewer than 10 employees. In addition, there are exceptions for employees of certain railroads, Federal government employees, and incarcerated prisoners.
<http://www.ic.nc.gov/ncic/pages/statute/97-2.htm>
<http://www.ic.nc.gov/ncic/pages/statute/97-13.htm>

³ Developed by the Government Data Analytics Center (GDAC) in collaboration with SAS Institute, Inc.



Source: Commission data

Though the implementation of NETS has led to several improvements, room for further improvements exist and are detailed in the subsequent sections of this report.



OBJECTIVE, SCOPE, AND METHODOLOGY

The audit objective was to determine whether the North Carolina Industrial Commission (Commission) is effectively ensuring compliance with the North Carolina Workers' Compensation Act (Act).

The audit scope included an analysis of the Workers' Compensation Program beginning January 1, 2014, through June 30, 2016.

To accomplish the audit objectives, auditors interviewed personnel, observed operations, reviewed policies, analyzed records, and examined documentation supporting transactions, as considered necessary in the circumstances.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

As a basis for evaluating internal control, auditors applied the internal control guidance contained in professional auditing standards. As discussed in the standards, internal control consists of five interrelated components, which are (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

We conducted this performance audit 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.



FINDINGS, RECOMMENDATIONS, AND RESPONSES

1. ALL NONCOMPLIANT BUSINESSES STILL NOT IDENTIFIED, RESULTING IN FINANCIAL DIFFICULTIES FOR INJURED WORKERS

The Office of the State Auditor first reported the North Carolina Industrial Commission (Commission) lacked complete, accurate, and reliable data necessary to proactively identify noncompliant businesses in 2013. The Commission still has not implemented a system to identify all businesses without workers' compensation insurance.

Auditors estimate that up to 52,000⁴ businesses lacked workers' compensation coverage as of June 2016. Until the Commission improves its noncompliant business identification process, North Carolina's citizens remain at risk of being injured at work while not covered by Workers' Compensation insurance.

Detection Is Incomplete

The Commission has not implemented a system to identify and detect all businesses that are noncompliant with the Workers' Compensation Act.

The Noncompliant Employer Targeting System (NETS) analytics only identifies businesses or employers that carried workers' compensation insurance in the past but subsequently dropped that coverage. Businesses or employers that have never carried the required insurance are not identified. Additionally, newly created businesses and uncovered businesses that close and then reopen under a new name may not be identified.

Incomplete Detection Puts Employees at Risk

Workers' compensation is a type of insurance that covers an employee's medical expenses and lost wages when involved in a job related injury. Without workers' compensation, injured employees may be left without wage replacement and medical benefits.

Because the Commission does not identify all businesses that operate without workers' compensation insurance, employees injured at those businesses have had a difficult time getting medical bills paid and receiving lost wages even when the Commission made an award to the injured worker. Without workers' compensation insurance in place, some businesses have trouble paying awarded amounts.

For example:⁵

- One employee injured at a business that did not carry workers' compensation insurance is still waiting for his payment of more than \$183,000 awarded in 2013 by

⁴ The Workers' Compensation Act requires companies with three or more employees doing business in North Carolina, unless exempt, to maintain workers' compensation insurance that covers an employee's medical expenses and lost wages when involved in a job related injury. Employers are exempt from the Workers' Compensation Act if they employ fewer than three employees (no exemption applies if activities involve the use or presence of radiation), are in the agriculture or domestic service businesses and employ fewer than 10 employees, or operate a sawmill or logging company with fewer than 10 employees. In addition, there are exceptions for employees of certain railroads, Federal government employees, and incarcerated prisoners.

⁵ The following examples illustrate what may happen to employees injured in the workplace when businesses operate without workers' compensation insurance. Even though the Commission ordered the company to pay, payment of medical expenses and wages were delayed or not paid. Having the insurance in place would eliminate this problem.

the Commission. This employee broke his pelvis and back in a fall, which also resulted in internal bleeding. He still requires medical treatment and cannot pay his medical bills because he has been unable to resume working.

- Another employee injured at a business that did not carry workers' compensation insurance was awarded \$19,000 in 2013 for wages and medical costs after injuring her lower back. Her employer paid her medical bills more than three years late, resulting in denied treatment by her doctor and phone calls from collection agencies. She has been unable to return to work.

Neither the Commission nor the Rate Bureau know how many businesses have never had Workers' Compensation insurance. Auditors asked the Commission and the NC Rate Bureau for the number of businesses that have never had Workers' Compensation insurance, but neither entity was able to produce that number.

However, the number of citizens at risk could be significant. Auditors estimate that the number of uninsured businesses could be as many as 52,000 as of June 2016. Auditors compared the number of businesses with three or more employees⁶ to the number of businesses with enforceable workers' compensation policies⁷ to estimate the number of businesses that did not have the required insurance.

The 52,000 estimate does not take into account businesses that may be exempt from carrying workers' compensation insurance, such as agriculture or domestic service businesses that employ fewer than 10 employees. Neither the Commission nor the NC Rate Bureau could provide the number of exempt businesses.

Until the Commission improves its noncompliant business identification process, workers remain at financial risk.

Management Decision Delayed Identification of All Businesses

According to the Commission, the Commission and the Government Data Analytics Center (GDAC) decided to develop a system quickly by using readily available data.⁸ They intended to get the first part of a comprehensive tool in place and continually enhance the system.

It has now been three and a half years since the Office of the State Auditor first reported the Commission's lack of complete, accurate, and reliable data necessary to proactively identify noncompliant businesses. Still, the Commission cannot perform a two-way match of data from the Department of Commerce to the NC Rate Bureau. This would potentially identify businesses or employers that have never had workers' compensation insurance.

While GDAC reports that a two-way match and some additional data sources are tentatively scheduled to be incorporated into NETS in fall 2016, there is no documentation that specifies when these enhancements will occur.

⁶ Reported by Dun & Bradstreet, a reputable business tracking organization. 217,341 businesses with three or more employees as of June 2016.

⁷ Reported by the NC Rate Bureau. 165,382 enforceable policies as of June 2016.

⁸ The Commission reports bringing 1,300 businesses into compliance since 2014. This represents 2.5% of 52,000 businesses potentially operating without workers' compensation insurance.

Best Practices Require Oversight

Best practices require the Commission to monitor regulated entities. Specifically, the National State Auditors Association states:⁹

“A governing body has the responsibility for developing a systematic process for monitoring regulated people’s/entities’ activities to ensure that they are following the applicable requirements and that the public is adequately protected.”

Additionally, other states have systems to ensure identification of noncompliant businesses. For example, Florida matches data from its insurance coverage database (similar to the NC Rate Bureau) to data maintained at its Department of Revenue, potentially identifying nearly all businesses without insurance coverage.

RECOMMENDATIONS

The Commission should continue to work with the Government Data Analytics Center to obtain the complete, accurate, and timely data necessary to perform data matching and identify noncompliant businesses that have never carried the required insurance.

AGENCY RESPONSE

See page 14 for the Commission’s response to this finding.

2. INVESTIGATIVE PROCESS NOT COMPLETED TIMELY, MAKING RECOVERY OF MEDICAL COSTS AND LOST WAGES MORE DIFFICULT FOR INJURED WORKERS

Since 2014, the North Carolina Industrial Commission (Commission) has taken longer to investigate businesses. As a result, non-covered employees may have a difficult time getting medical bills paid and receiving back wages. An increase in the number of potential noncompliant businesses and the lack of investigation performance goals and measures may be factors in the increased investigative time.

The Time it Takes to Investigate Potential Noncompliant Businesses is Increasing

Recently, it has taken more than a year for the Commission to assign and close cases.

For example, the assignment and investigation of one case closed in 2015 took 630 days. A case that closed in 2016 ran 725 days before the assignment and investigation were complete.

⁹ Carrying Out a State Regulatory Program – A National State Auditors Association Best Practices Document – 2004.

As noted below, most of the delay can be attributed to how long it takes to assign a case.

	Average Number of days (range) per calendar year:^{10,11}		
	2014¹²	2015	2016¹³
From date identified to date assigned to an investigator	84 (1 to 244)	360 (3 to 618)	590 (148 to 714)
From date assigned to an investigator to date closed	<u>36 (0 to 218)</u>	<u>72 (0 to 566)</u>	<u>42 (0 to 514)</u>
Total Time	120 (3 to 270)	432 (90 to 630)	632 (161 to 725)
Number of cases closed ¹⁴	1,172	1,248	371

Source: Auditor analysis of Commission records

Increased Investigation Time Puts Employees at Risk

Because of the amount of time it takes for the Commission to assign and investigate a potential case of lapsed or no workers’ compensation insurance, an injured employee may have a difficult time getting medical bills paid and receiving lost wages.

Workers’ compensation is a type of insurance that covers an employee’s medical expenses and lost wages when involved in a job related injury. Without workers’ compensation, injured employees may be left without wage replacement and medical benefits.

Increase in Investigative Time May be Due to an Increase in Cases

Since the Noncompliant Employer Targeting System (NETS) went live in April 2014, the number of cases of potential noncompliance that required Commission investigation increased significantly. In fact, approximately 5,000 alerts were generated on the first day alone.

Period	Number of Alerts	
	Average per Month	Total for Period
April 2014 – December 2014 ¹²	788	7,089
January 2015 – December 2015	475	5,690
January 2016 – March 2016 ¹³	709	2,127
Total		14,906

Source: Auditor analysis of Commission records

¹⁰ Based on cases with disposition dates in the applicable year.

¹¹ The analysis used the initial alert date or the first date that the business or employer was identified as potentially noncompliant.

¹² Beginning April 14, 2014.

¹³ Through March 30, 2016.

¹⁴ Analysis includes cases that were initiated and closed by the Compliance Unit. Analysis does not include those initiated and closed by the Fraud Investigations Unit. These cases were not included due to differences in the process in which these cases were assigned and investigated. Total cases closed during audit period was 4,250.

The Commission estimates that before NETS, it investigated 500 cases per year, or 42 a month on average.

Commission Says it Lacks the Resources to Perform Timely Investigations

The Commission says that it does not have adequate resources to ensure that all potentially noncompliant businesses are investigated timely. Currently, the Commission has five positions dedicated to investigating the alerts that are created in the NETS software tool.

Without an increase in staff, the Commission believes the time it takes to investigate potential noncompliant businesses will continue to increase. As the NETS software tool begins to use new data sources to identify businesses or employers that have never carried the required insurance, the number of alerts will also increase.

However, the Commission has not yet determined how long it takes, or should take, to investigate a potential noncompliant business. Until that analysis is done, the Commission can not determine the correct number of inspectors to handle the current or future volume of NETS generated alerts.

Investigative Time Not Managed with Program Goals or Performance Measures

The Commission has not defined goals and objectives, or developed performance measures for how long it should take to complete an investigation in the Compliance program.

When asked why the program did not have goals, objectives, or performance measures, management stated that the compliance program is still in its early development phase and that it is too early to develop goals and objectives or performance measures.

Programs in Other States Have Goals and Performance Measures

Programs in other states charged with investigating workers' compensation noncompliance have set goals and performance measures.¹⁵

For example, the Florida Division of Workers' Compensation requires staff to investigate on-site and has set deadlines for noncompliance investigations:

- On-site investigations to be initiated within 30 days for cases identified through data matching
- Investigations to be completed within 10 days once on-site
- Noncompliant employers have 28 business days to comply

Also, the Arkansas Workers' Compensation Commission has set deadlines for noncompliance investigations:

- Once Arkansas identifies a potentially noncompliant business, it begins investigating within 24 hours
- Investigations should be completed in no more than 12 days

¹⁵ The examples below are not meant to compare to the Commission's investigative timeliness to the other states. It is meant to show that other states have set goals and measures and the Commission has not. Readers should not make comparisons of timeliness because of the differences in processes and tools used.

- Businesses have 20 days to respond with proof of coverage or other explanation

RECOMMENDATIONS

The Commission should set clear, specific goals that are linked to and measured by performance measures so that decision-makers can evaluate the Commission's performance.

Management should review and approve key agency indicators to ensure they are outcome-based and measure goal achievement.

Management should require the measures to be reported periodically, monitor the measures, and use the measures in decision making.

The Commission should determine the appropriate number of investigators needed to perform timely investigations and should seek the necessary resources to fill those positions.

AGENCY RESPONSE

See page 16 for the Commission's response to this finding.

3. INADEQUATE OVERSIGHT OF INVESTIGATION AND PENALTY CANCELLATION PROCESS INCREASES OPPORTUNITY FOR NONCOMPLIANCE

The North Carolina Industrial Commission's (Commission) oversight of its investigation and penalization processes is inadequate. Lack of adequate oversight increases the risk that businesses are operating without workers' compensation insurance and assessed penalties are not collected.

Investigations Closed Without Management Review

Not all investigated cases of potential noncompliance receive supervisory review.

Cases that do not result in an assessed penalty can be closed without supervisory review. For example, an investigator may decide a business is no longer operating, has coverage under another policy or is classified as exempt by the Workers' Compensation Act. These cases are not reviewed by management.

Without review, there is an increased risk that cases are being closed incorrectly, allowing these businesses to continue operating without insurance coverage.

Penalty Invoices Canceled Without Management Oversight

Penalty invoices¹⁶ are canceled without prior approval or review by management. In SFY15, 810 penalty invoices totaling \$9,354,317 were canceled.

¹⁶ The Commission assesses penalties to businesses that fail to carry insurance coverage. The Commission collects these penalties by issuing invoices.

Invoices can be canceled for numerous valid reasons, including errors, penalty reductions or dismissals, or the completion of payment.¹⁷

Without prior approval or review, management does not know if the invoices were canceled properly.

Improperly canceled penalty invoices increases the risk that the Commission is not collecting all assessed penalties, which makes businesses less likely to maintain coverage.

Management Believes Oversight is Sufficient

When asked why all investigated cases did not receive a review and why penalty invoices are canceled without review, management explained that they believe they provide sufficient oversight.

Management stated that due to the high number of false positives and the Commission's limited resources, it was more efficient and effective to review only cases of staff who need more guidance.

Management stated that they oversee penalty invoice cancelation by being copied on the emails between the paralegals and the accounting section. They also said that monthly installment payment plans are reviewed, although this monitoring is not documented.

Supervisory Review is Needed to Verify Transactions

While the Commission believes it provides sufficient oversight of closed cases and canceled invoices, best practices call for at least some direct supervisory oversight of transactions processed by staff.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)¹⁸ wrote that supervisory controls, such as verifications and approvals, are appropriate controls to ensure the completeness, accuracy, and validity of transactions processed by staff.¹⁹

RECOMMENDATIONS

The Commission should design and/or put into effect policies and procedures to provide reasonable assurance that transactions processed by the staff are complete, accurate, and valid and that regulatory objectives are met.

AGENCY RESPONSE

See page 17 for the Commission's response to this finding.

¹⁷ The Commission's current accounting software cannot track monthly payments toward an invoiced penalty. Paralegals enter a new invoice each month for each business on a payment plan. When the payment plan is completed, the invoice for the total penalty must be canceled to avoid overstating what the business owed.

¹⁸ COSO is a committee of five business and accounting organizations whose representatives come together periodically to work on risk management, internal control, and fraud deterrence. In setting internal control standards for state agencies, the Office of the State Controller adopted the internal framework established by COSO.

¹⁹ COSO's Internal Control – Integrated Framework, May 2013



STATE AUDITOR'S RESPONSE

The Office of the State Auditor is required to provide additional explanation when an agency's response could potentially cloud an issue, mislead the reader, or inappropriately minimize the importance of auditor findings.

Generally Accepted Government Auditing Standards state,

"When the audited entity's comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditor's recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement."

The Commission's response indicates that it agrees with the report's recommendation to obtain the complete, accurate, and timely data necessary to perform data matching and identify noncompliant businesses that have never carried the required insurance.

However, the Commission states that it has concerns with the estimated number of 52,000 possible uninsured businesses cited in the report. Using its own methodology, the Commission concludes that it "appears" that many employers likely subject to the Workers' Compensation Act already have the required coverage.

The fact that is being diminished in the Commission's response is that the Commission **does not know** how many businesses do not carry workers' compensation insurance, and they **will not know** until they have the capacity to match and investigate all non-exempted businesses to businesses that carry workers' compensation insurance.

Instead of disputing the estimate, the Commission's response should focus on the potentially tens of thousands of businesses without workers' compensation insurance operating in the state that puts tens of thousands of workers at risk of injury without wage replacement and medical benefits.

Even if the actual number of uninsured businesses operating in North Carolina subject to the Workers' Compensation Act is half of what the report estimates (26,000) and those businesses employ the minimum number of employees that generally requires businesses to carry workers' compensation insurance (three), 78,000 employees would be at risk of injury without wage replacement and medical benefits.

The only way to know and protect against the risk to these employees is to improve and expand the Commission's system to identify uninsured businesses. The Commission agrees with this and its response states that the new database has been tested and is fully functional, pending the execution of memoranda of understandings (MOUs) between appropriate parties.

If the Commission's efforts to identify all uninsured businesses is being delayed by non-executed MOUs, then it should seek the assistance of the Governor and the General Assembly to get the MOU's executed and further protect North Carolina workers.

The Governor, Legislators, and the citizens of North Carolina should consider this clarification when evaluating the Commission's response to the audit finding.



RESPONSE FROM NORTH CAROLINA INDUSTRIAL COMMISSION

Pat McCrory, Governor
Charlton L. Allen, Chairman



Bernadine S. Ballance, Commissioner
Linda Cheatham, Commissioner
Bill Daughtridge, Jr., Commissioner
Christopher C. Loutit, Commissioner
Tammy R. Nance, Commissioner

North Carolina Industrial Commission

November 15, 2016

VIA ELECTRONIC MAIL AND HAND DELIVERY

The Honorable Beth A. Wood, State Auditor
Office of the State Auditor
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0600

Dear Auditor Wood:

On behalf of the North Carolina Industrial Commission, thank you for the work that your team performed in auditing the policies and procedures of the Industrial Commission. We are always interested in working with other state agencies to maximize resources and to improve our efficiencies. We appreciate the opportunity to respond to the findings and recommendations of your office's performance audit report.

It is important to keep in mind the following points about the Commission's Compliance and Fraud Investigation Section as you read through the Commission's response to each audit finding and recommendation:

- The Commission's proactive compliance program targeting noninsured employers is still a new program and has not been fully developed or implemented.
- The Commission's Compliance and Fraud Investigation Section has demonstrated substantial progress in only three years, showing consistent annual increases in cases closed, penalties collected, and criminal charges issued.
- Much of what the audit report recommends has already been planned for and is either implemented or in the process of being implemented by the Commission.

In reference to the performance audit report findings and recommendations, the Commission responds in detail as follows:

A) BACKGROUND: THE FEBRUARY 2013 AUDIT

In February 2013, the Office of the State Auditor released a Performance Audit regarding the operations of the North Carolina Industrial Commission ("the Commission"). The specific purpose of the audit was to determine if the Commission was effectively ensuring compliance with the North Carolina Workers' Compensation Act through the evaluation of measures to ensure that businesses maintain workers' compensation insurance coverage as well as to assess and collect

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penalties for noncompliance. In the February 2013 performance audit report, the Auditor's Office set out three recommendations to the Commission:

- 1) The North Carolina Industrial Commission should continue working with the North Carolina Rate Bureau and the Division of Employment Security to obtain the complete, accurate, and reliable data necessary to perform data matching and identify noncompliant businesses. To identify best practices and ideas for improvements, the Industrial Commission should also consider contacting other states that have a data matching program.
- 2) The Commission should implement policies and procedures to follow up with businesses that cancel their workers' compensation coverage or let their coverage lapse. If there is not a valid reason for the cancellation or lapse, penalties should be assessed in accordance with state law.
- 3) The Commission should consider stricter enforcement of penalty assessments and collections in accordance with its authority under state law.

The Commission took these recommendations very seriously. Commission management went to the North Carolina General Assembly to request additional resources in order to address these issues. The additional resources allowed the Commission to create 13 new positions to add to the existing team of five members. In July 2013, the Commission also hired a Director of Compliance and Fraud Investigations ("the Director") to carry out the expansion of the Compliance and Fraud Investigation staff.

The Director and staff worked with the Government Data Analytics Center ("GDAC"), the Division of Employment Security ("DES"), and the North Carolina Rate Bureau ("NCRB") to execute memoranda of understanding ("MOUs") and data access and use agreements ("DAUAs") so that each entity could share information. The goal was to develop an analytical tool that would identify potential noncompliant businesses in North Carolina. On April 14, 2014, after months of development work and meetings with SAS Institute, Inc. ("SAS") and GDAC, the Commission began using an application built by SAS, later named the Noncompliant Employer Targeting System ("NETS"), that analyzes data from DES and NCRB to determine if a business is reporting three or more employees and, if so, whether or not they have ongoing workers' compensation coverage.¹ The analytics also included address information from the North Carolina Secretary of State's office ("SOS") to ensure that the most current contact information is used.

The implementation of the NETS program directly addressed Recommendations #1 and #2 of the February 2013 Audit. Since April 2014, there have been several updates to the NETS system, including the addition of information regarding self-insured employers and Professional Employer Organizations ("PEO"), as well as "filed claims" data from the Commission. The number of false positives initially identified by the system has been substantially reduced as a result of these improvements. The verification of false positives during investigations has also allowed the correction of data collected in NETS.

Using the NETS system, the Commission has investigated and closed over 6,000 cases as of the writing of this response and brought over 1,300 businesses into compliance. The

¹ See N.C. Gen. Stat. §§ 97-2(1), 97-9, 97-93.

Commission has increased its collection of penalties for noncompliance each year, collecting \$341,922 in fiscal year 2013-14, \$992,965 in fiscal year 2014-15, and \$1,495,963 in fiscal year 2015-16. The Commission has collected over \$2.5 million since April 2014. NETS has also been an important tool for the Fraud Investigators. Using NETS with claims data to identify businesses that are willfully in violation of the law, Commission Fraud Investigators have dramatically increased the number of criminal charges issued against noncompliant employers.

The Commission also addressed Recommendation #3 of the February 2013 audit report concerning penalty collection activities. The Commission regularly holds penalty and contempt hearings to enforce and collect the penalties assessed by the Commission. The Commission requested the Office of State Budget and Management, Office of Internal Audit, review the collections process with regard to penalties. This review was produced in early 2015.

In short, the Commission responded appropriately to the February 2013 audit report and has made much progress since that time. The Commission has developed and implemented a data-matching analytics program that matches data from DES and from NCRB to identify those businesses that may undergo a lapse in coverage or may drop their coverage. The Commission undertook significant steps to comply with the recommendations of the February 2013 audit report and continues to evaluate and update its programs.

B) THE FOLLOW-UP / SECOND AUDIT

The Auditor's Office contacted the Commission on October 28, 2015, to inform the Commission that a follow-up audit would be conducted with the stated objective being to determine if recommendations from the February 2013 audit report had been implemented.²

Following a thorough review of the final draft performance audit report³ furnished to the Commission on November 1, 2016, the Commission responds to the auditors' findings and recommendations as follows:

FIRST FINDING: *All noncompliant businesses still not identified, resulting in financial difficulties for injured workers*

FIRST RECOMMENDATION: *The Commission should continue to work with the Government Data Analytics Center to obtain the complete, accurate, and timely data necessary to perform data matching and identify noncompliant businesses that have never carried the required insurance.*

INDUSTRIAL COMMISSION ACTION PLAN SUMMARY: The Commission will continue working with GDAC and other state agencies to obtain the most accurate data available to use in

² On March 29, 2016, the Commission was informed by letter that the scope and objectives of the audit would be expanded.

³ The Commission notes that, the second paragraph of the Background section of the audit report characterizes the reason for creation of the Industrial Commission as being "to track compliance with the prompt payment of compensation and to resolve requests for, or disputes involving, medical compensation." This is merely a restatement of N.C. Gen. Stat. § 97-78(f) and (g), which reflect only two of the many components involved in the Commission's mission to administer the North Carolina Workers' Compensation Act and adjudicate all claims arising thereunder.

its data analytics to identify noncompliant employers. The Commission will continue to cooperate in the timely development and execution of all necessary agreements for the exchange of data.

INDUSTRIAL COMMISSION RESPONSE:

The Commission agrees with the first recommendation, but disagrees with certain points of the audit report's supporting analysis.

The Commission has already taken steps to implement the first and second recommendations from the February 2013 audit report, and continues to move this program forward. The Commission worked with GDAC to create NETS, a data analytics software application that uses data from DES, NCRB, SOS, and the Department of Insurance ("DOI"), as well as the Commission's claims data. The Commission has continued to work with GDAC on improvements and updates to NETS and has also been working with GDAC and other state agencies to develop a second database that analyzes additional information to identify potentially noncompliant businesses associated with employers that do not comply with various state requirements.

This second database has been tested and is fully functional, pending the execution of MOUs between appropriate parties. This new database will provide the two-way match that was not available in the initial release of NETS, thus identifying businesses that are in the DES data but do not appear in the NCRB's current policy data and may never have had insurance. The initial release of NETS only contained a one-way match that identifies businesses potentially subject to the Workers' Compensation Act per DES data that appear to have lapsed or cancelled insurance coverage in the NCRB historical policy data. Thus, the Commission has demonstrated its progress and its intention to continue working with GDAC to significantly improve our alerting capabilities.

In response to the audit report's mention that Florida uses its Department of Revenue data to identify uninsured businesses, please note that the Commission does not have access to similar data from the North Carolina Department of Revenue ("DOR") due to North Carolina General Statute § 105-259. The Commission also conferred with the North Carolina Department of Labor regarding sharing data, but it does not have data that would assist the analytics performed by NETS.

While the Commission agrees with this first recommendation and has been pursuing the actions recommended, the Commission has concerns with the estimated number of 52,000 possible uninsured businesses operating in North Carolina cited in the audit report. This estimate is based on a figure of 217,341 businesses in North Carolina with three or more employees reflected in a Dun & Bradstreet⁴ report, minus the 165,382 policies reported to the NCRB by insurance carriers.⁵ This Dun & Bradstreet figure is a general estimate with no citation or explanation as to how the number was derived. The audit report states that the estimate does not take into account businesses that may be exempt from carrying workers' compensation insurance. Importantly, this number could be quite substantial. Additionally, the audit report estimate does not appear to account for employers who self-insure or are covered by a self-insured fund or a PEO umbrella policy and,

⁴ Dun & Bradstreet is a business data and analytics company.

⁵ See Audit Report Footnotes 4-5.

therefore, would not be included in the policies reported to NCRB. Further, based upon the Commission's experience in investigating possible uninsured business leads, the Commission projects a substantial likelihood of false positives inherent in this estimate.

To provide further context, the Commission recently inquired with the North Carolina Department of Commerce ("DOC") regarding the number of employers in North Carolina that are potentially subject to the Workers' Compensation Act based on their number of employees. DOC indicated that there were 259,491 private sector employers in North Carolina in 2015, the most recent year available.⁶ DOC indicated that 153,322 of these employers employed between one and four employees, while 106,169 employed five or more employees. If one were to combine all 106,169 employers with a portion of the 153,322 employers and compare that estimated figure to the 165,382 policies reported to the NCRB, it would appear that many of the employers likely subject to the Workers' Compensation Act have the required coverage.

Given the potential disparity in results derived from very general numbers, the Commission is cautious in providing any estimates that can be misleading or that would not be useful to policymakers. Considering that the Commission must use a custom data-matching program to identify noncompliant employers and has come across numerous false positives, such estimates have the potential to oversimplify the problem of identifying noncompliant businesses. The Commission eagerly anticipates full implementation of the two-way matching system, which the Commission believes will greatly assist in identifying the population it is charged with regulating.

SECOND FINDING: Investigative process not completed timely, making recovery of medical costs and lost wages more difficult for injured workers

SECOND RECOMMENDATION: The Commission should set clear, specific goals that are linked to and measured by performance measures so that decision-makers can evaluate the Commission's performance. Management should review and approve key agency indicators to ensure they are outcome-based and measure goal achievement. Management should require the measures to be reported periodically, monitor the measures, and use the measures in decision making. The Commission should determine the appropriate number of investigators needed to perform timely investigations and should seek the necessary resources to fill those positions.

INDUSTRIAL COMMISSION ACTION PLAN SUMMARY: To supplement the Commission's procedures and monitoring of statistics already in place, the Commission management and the Director will consider and implement goals and measures that will assist the Commission in performance evaluation and decision making. The Commission has begun this process and expects implementation to be completed within 2-3 months, including a period for feedback and adjustment. Commission management has submitted a draft budget expansion request to DOC for the creation of additional Compliance Officer positions in the next budget cycle.

INDUSTRIAL COMMISSION RESPONSE:

The Commission agrees with the second recommendation.

⁶ DOC indicated that these statistics were available at <http://d4.nccommerce.com/QCEWSelection.aspx> using the Industry by Size Groups data.

With respect to the recommendation that the Commission set specific goals and performance measures, the Commission acknowledges that the policies and procedures for the Compliance and Fraud Investigation Section can be refined to better address the responsibilities of management and employees as staffing and efficiency increase. The Director already monitors several valuable statistics that indicate the work output by staff. As the audit report acknowledges, once an alert is assigned for investigation, the Compliance staff averages closing a case in 42 days. Taking into account case-by-case variations in complexity, the Commission will review its work output levels and establish appropriate goals.

With respect to the finding that the Commission's investigations process is not completed in a timely manner, the Commission acknowledges that there can be a significant delay between receipt of an alert and assignment of the alert for investigation. This is a resources and staffing issue. When the Commission first expanded the Compliance and Fraud Investigation Section following the February 2013 audit report, it requested the creation of 13 positions based on initial alert estimates. However, the Commission received many more alerts than initially estimated. On the first day NETS went live, 5,000 alerts were generated, and significant numbers of alerts continue to be delivered at periodic intervals.

The audit report recommends that the Commission assess its staffing needs and seek the necessary resources to conduct timely investigations. With over two years of staff experience using NETS, the Commission is more confident in its workload distribution, and is also preparing for the expected increase upon the activation of the second database. The Commission recently submitted a draft budget expansion request to DOC for the fiscal biennium 2017-19 to allow for the creation of additional Compliance Officer positions. With this request, the Commission aims to reduce significantly the period of time between alert receipt and assignment for investigation.

THIRD FINDING: Inadequate oversight of investigation and penalty cancellation process increases opportunity for noncompliance

THIRD RECOMMENDATION: The Commission should design and/or put into effect policies and procedures to provide reasonable assurance that transactions processed by the staff are complete, accurate, and valid and that regulatory objectives are met.

INDUSTRIAL COMMISSION ACTION PLAN SUMMARY: The Commission will enhance oversight of the investigation closure and penalty cancellation processes and review these procedures periodically. In addition to reviewing each case assigned for penalty assessment, the Director will review randomly selected case investigations that are closed without penalty assessment by the Compliance Officers. This additional review began during the audit period and will continue to occur on a monthly basis. The Commission's accounts receivable manager is now reviewing the cancelled penalty invoices and will continue to do so on a monthly basis.

INDUSTRIAL COMMISSION RESPONSE:

The Commission believes it exercised adequate oversight of the investigation and penalty cancellation processes. Nevertheless, the Commission has implemented additional processes to address the third recommendation in the audit report.

The Commission will first address the oversight of the investigation process. The Compliance Unit includes both Compliance Officer and Compliance Examiner positions. The Compliance Examiner positions require a lower level of experience and education than the Compliance Officer positions, therefore requiring more oversight from management. Initially, all cases recommended for closure without penalty assessment by the Compliance Examiners were presented to the Compliance Officers for review. However, to allow the Compliance Officers to focus on investigating additional pending cases, the Director took over that responsibility. The Compliance Officer positions were filled with staff with more knowledge and experience, and were therefore allowed to close cases not assigned for penalty assessment without management review. The Director has always reviewed every case that is closed and assigned for penalty assessment.

In light of feedback from the auditors during their fieldwork, the Commission adjusted its process and the Director now reviews randomly selected cases closed without penalty assessment by the Compliance Officers each month for quality assurance.

With respect to management oversight of penalty invoice cancellations, it was reasonably believed that the Commission had sufficient internal controls to effectively monitor this process because no one in the Compliance Unit, including the Director, has the access rights to cancel an invoice. However, in light of feedback from the auditors during their fieldwork, the Commission has taken steps to add an additional level of review. The Commission's accounts receivable manager, who is not a part of the Compliance Unit, now reviews records of the cancelled penalty invoices to supplement the existing separation of duties. The Commission will continue to assess the risk of improperly cancelled invoices and refine its procedures, if necessary.

C) CONCLUSION

The Commission has made significant progress since the original February 2013 audit report in building its Compliance and Fraud Investigation Section, working with GDAC and other state agencies, and developing NETS. The Commission does not disagree with the audit report's recommendations and is, in fact, working on all of these objectives. The Commission appreciates the opportunity to work with other state agencies and values outside perspectives as we continue to develop our Compliance and Fraud Investigation Section and pursue our mission of tracking and enforcing compliance with workers' compensation insurance requirements.

Respectfully,



Charlton L. Allen
Chairman

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This audit required 3,985 hours at an approximate cost of \$400,895.