

LEGISLATIVE AUDIT DIVISION

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MEMORANDUM

TO: Legislative Audit Committee Members
FROM: Angie Grove, Deputy Legislative Auditor
DATE: November 2010
CC: Lawrence Hubbard, President/Chief Executive Officer, Montana State Fund
Patti Grosfield, Internal Auditor, Montana State Fund
RE: Performance Audit Follow-up (11SP-04): Montana State Fund Corporate Governance Practices (08P-08)
ATTACHMENT: Original Performance Audit Summary

Introduction

In February 2009, we presented our performance audit on Montana State Fund Corporate Governance Practices. The audit made six recommendations directed to the Montana State Fund. In September 2010, we began gathering preliminary information from the agency on its progress in implementing the recommendations. This memo summarizes the results of our follow-up work in addition to presenting background information on structure of Montana State Fund and its role in the state's workers' compensation insurance system.

Overview

Our audit contained six recommendations directed either to Montana State Fund executive management or to the organization's Board of Directors. Audit recommendations addressed improvements in corporate governance policies or practices that could strengthen accountability and promote transparency in Montana State Fund operations. In its response, the agency indicated preliminary concurrence with all the recommendations, but deferred to its Board of Directors on final decisions in some areas. Our audit follow-up work shows Montana State Fund has generally made good progress in implementing most of the recommendations. However, one recommendation, relating to disclosure of executive compensation data, has not been implemented.

Background

The Montana State Fund (MSF) operates as an independent nonprofit public corporation providing workers' compensation insurance coverage for the state's employers. Management and control of MSF is vested solely in its Board of Directors (the board), which is appointed by the Governor. The board must operate the fund as a self-sustaining business. To this end, MSF has adopted many management practices of private, for profit businesses. Due in part to its unique mission, and the large degree of autonomy and

flexibility accorded to MSF and its board, we focused audit work to address issues relating to corporate governance. Corporate governance encompasses certain issues, which include the composition, structure and duties of an independent board of directors; accountability and oversight roles designated to the board and executive management; auditing and disclosure of financial and operational information; compensation policies; and communication with stakeholders.

Audit recommendations addressed improvements in corporate governance policies or practices to strengthen accountability and promote transparency in MSF operations. Six recommendations were made to MSF in conjunction with its board and addressed the following issues.

- ▶ Using board committee structures to provide in-depth review of the business.
- ▶ Establishing a direct reporting relationship between the MSF Internal Auditor and the board.
- ▶ Identifying metrics and expectations regarding qualitative measures of business performance.
- ▶ Making annual public disclosures of executive compensation.
- ▶ Separating compensation consulting contracts for CEO compensation.
- ▶ Developing clawback policies to improve the ability of MSF to collect incentive payments made in error.

Follow-up Audit Findings

In its response to the original audit report, MSF indicated preliminary concurrence with all the recommendations, but also noted certain decisions implementing recommendations would be subject to the approval of the board. As part of audit follow-up work, we reviewed agency and board documents relating to the audit recommendations and interviewed agency staff. Over the past 18 months, MSF in conjunction with the board have taken various actions to address audit recommendations. The implementation status of each recommendation is discussed in the following sections.

Recommendation #1

We recommend the Montana State Fund work with its Board of Directors to identify areas of the business where committee charters could be developed to provide in-depth review.

Implementation Status – Implemented

Acting on the advice of MSF management, the board considered various proposals identifying areas of the business where committee charters could be developed. The board took action to address this recommendation in November 2009 by approving a Compensation Committee Charter. The mission of this committee as established in the charter is to facilitate and assist the full Board in fulfilling the Board's responsibilities in relation to the compensation of the President/Chief Executive Officer (CEO). At least three board members are appointed to serve on the committee, which will meet at least annually to address issues relating to CEO compensation.

Recommendation #2

We recommend the Montana State Fund revise its Internal Audit Charter to provide for a direct reporting relationship between the Board of Directors and the internal audit function.

Implementation Status – Implemented

In June 2009, the board approved changes to the existing internal audit charter to strengthen the relationship between the board/board members and the MSF internal audit function. These changes

clarified the reporting relationship between the MSF employee serving as Internal Auditor and the individual board members.

Recommendation #3

We recommend the Montana State Fund review existing performance management data to determine whether defined expectations of performance relative to qualitative success measures can be integrated in the business planning process.

Implementation Status – Implemented

MSF addressed this recommendation through changes to its strategic business planning process, which resulted in a more prominent role for qualitative success measures in the annual business plan. Review of the fiscal year 2011 strategic business plan shows the sections addressing enterprise-wide initiatives have been updated to include defined expectations of performance relative to non-financial or qualitative success measures. For fiscal year 2011, MSF enterprise-wide initiatives addressed workforce management and development, customer service, and infrastructure. In each case, several different qualitative success measures were included with specific, defined performance expectations.

Recommendation #4

We recommend the Montana State Fund prepare and publicly distribute executive compensation disclosures as part of the process for releasing its annual financial report.

Implementation Status – Not Implemented

Although the board has reviewed the issue of executive compensation disclosures, to date, no action has been taken to implement this recommendation. Disclosure of compensation for the highest paid executives within an organization is a commonly-enforced corporate governance standard and is a requirement for all publicly-traded entities in the United States. Creating and issuing an annual executive compensation disclosure through its annual reporting process would align MSF with best practices and accepted standards of corporate governance. In its response to our audit follow-up request, MSF indicated the board had considered these issues, but noted MSF employee compensation information is already available on request as a public record. This does not, however, address the kind of executive compensation disclosure practices discussed in the audit report and widely accepted as a corporate governance best practice.

Recommendation #5

We recommend the Montana State Fund separate compensation consulting contracts to provide a direct role for its Board of Directors in authorizing contracts for advice on Chief Executive Officer compensation.

Implementation Status – Implemented

The board took action on this recommendation in June 2009 by authorizing a separate compensation consulting contract for CEO compensation. Currently, the board contracts with the same compensation consulting business MSF retains for employee compensation issues, but now signs a separate contract specifically addressing issues relating to CEO compensation. Under the current CEO compensation consulting contract, the board chair is designated as the official contract liaison, in addition to authorizing the contract.

Recommendation #6

We recommend the Montana State Fund revise policies relating to executive and employee incentive programs to include clawback provisions or similar measures for recovering payments made in error.

Implementation Status – Being Implemented

MSF is currently in the process of revising its executive and employee incentive programs and plans to include clawback provisions or similar measures under these revisions. The agency has reported it is analyzing various options for how clawback provisions could be implemented and is seeking input from its contracted compensation consultant in developing these measures. For the past two fiscal years, MSF has not made any incentive payments to executives or employees under its incentive programs, so there have not been opportunities to actually apply this recommendation in practice. However, the agency appears to be actively considering the available options and is working toward implementation of this recommendation.

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