A Report
to the
Montana
Legislature

Performance Audit

Montana State Fund Corporate Governance Practices

Montana State Fund

February 2009

Legislative Audit
Division

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Performance Audits

Performance audits conducted by the Legislative Audit Division are designed to assess state government operations. From the audit work, a determination is made as to whether agencies and programs are accomplishing their purposes, and whether they can do so with greater efficiency and economy.

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.

Members of the performance audit staff hold degrees in disciplines appropriate to the audit process. Areas of expertise include business and public administration, journalism, accounting, economics, sociology, finance, political science, english, anthropology, computer science, education, international relations/security, and chemistry.

Performance audits are performed at the request of the Legislative Audit Committee which is a bicameral and bipartisan standing committee of the Montana Legislature. The committee consists of six members of the Senate and six members of the House of Representatives.

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LEGISLATIVE AUDIT DIVISION

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February 2009

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of corporate governance practices at Montana State Fund (MSF).

This report provides the Legislature information about general corporate governance standards at MSF, the role and responsibilities of the MSF Board of Directors, MSF risk management and business planning processes, and executive and MSF employee compensation policies and incentive programs. This report includes recommendations aimed at strengthening MSF corporate governance practices.

We wish to express our appreciation to MSF personnel and members of the Board of Directors for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

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Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard, President/CEO
	Mark Barry, Vice President, Corporate Support
	Richard Root, Vice President, Insurance Operations
	Peter Strauss, Vice President, Insurance Operations Support
	Nancy Butler, General Counsel
	Al Parisian, Chief Information Officer
State Fund Board of Directors	Joe Dwyer, Chairman
	Jane DeBruycker
	Thomas R. Heisler
	Ken Johnson
	Jim Swanson
	Boyd Taylor
	Wally Yovetich

Report Summary

Montana State Fund Corporate Governance Practices

Montana State Fund meets many standards for effective corporate governance; revisions to policies and practices could strengthen governance oversight and accountability.

Audit Findings

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.

MSF Information
2008

Policyholders	32,400
Claims	15,100
Employees	298
Total Assets	$1.2 billion
Total Liabilities	$973 million
Net Assets	$225 million

Source: Compiled by the Legislative Audit Division from MSF Records.

Our first audit objective addressed the composition and structure of the board. We reviewed board structures for competitive workers' compensation insurance funds in other states. This comparison showed the structure of the MSF board is broadly similar to peer businesses and meets minimum corporate governance standards. One area of difference between Montana and other state funds is the degree to which MSF is subject to regulatory supervision through the office of the Insurance Commissioner. We also identified use of board committee structures as an applicable best practice for corporate boards. Our second objective addressed the role of the board in risk management and the MSF business planning process. The MSF board can provide effective oversight of risk management activities, but could benefit from a more direct reporting relationship with the MSF Internal Audit function. The MSF business planning process functions as an effective means of ensuring executive management is accountable for business performance. One opportunity for improvement in business planning relates to reporting operational performance data.

Our third audit objective addressed MSF compensation policies. Our review showed MSF compensation policies have generally been developed in accordance with best practices and are consistent with its corporate identity. Although average salaries at MSF are comparable with state agencies with similar personnel needs, executive compensation levels tend to be higher. MSF compensation policies could be strengthened by addressing executive pay disclosures and the role of compensation consultants. Our final audit objective addressed MSF executive and employee incentive programs. MSF has established these programs to annually provide employees with an opportunity to earn a performance-based incentive payment, in addition to their regular salary. Overall, we found MSF incentive programs have been designed in accordance with best practices and are subject to appropriate controls. These programs could be strengthened by including clawback provisions, which are becoming a prevalent practice in the private sector and allow for recovery of incentive payments made in error.

Audit Recommendations

Audit recommendations address improvements in corporate governance policies or practices to strengthen accountability and promote transparency in MSF operations. Six recommendations are made to MSF in conjunction with its board and address 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 total compensation for the five highest-paid MSF executives.
- Separating compensation consulting contracts for CEO compensation.
- Developing clawback policies to improve the ability of MSF to collect incentive payments made in error.

Chapter I – Introduction and Background

Introduction

Montana State Fund (MSF) was established in its current form in 1990 as an independent nonprofit public corporation to provide workers' compensation insurance coverage for Montana employers. Workers' compensation insurance provides, without regard to fault, wage-loss and medical benefits to workers suffering from a work-related injury or disease. Montana employers have options for obtaining workers' compensation coverage for their employees, either through self-insurance, private insurance companies, or through MSF. Montana's workers' compensation insurance system establishes MSF as the guaranteed market insurer; although it functions in much the same manner as a private insurer, MSF cannot refuse to provide coverage for an employer.

MSF Status as an Independent NonProfit Public Corporation

Sections 39-71-2313, MCA, and 39-71-2315, MCA, define MSF as a nonprofit, independent public corporation with its management and control vested solely in the Board of Directors (the board). The MSF board is appointed by the Governor and is responsible for appointment of the MSF Chief Executive Officer (CEO), among other duties. The board is required by statute to operate the fund as a self-sustaining business in much the same way that a private mutual insurance business is run. To this end, MSF has adopted many of the management practices of private, for-profit businesses and is exempted under state law from some requirements applicable to state agencies. Because MSF operates as private business it has developed many organizational and operational features unique within state government.

Definition of Corporate Governance

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 corporate governance. Although corporate governance can be defined in many ways, we have used the following definition developed by the Organization for Economic Development Cooperation and Development (OECD).

> "Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

The concept of corporate governance generally encompasses certain issues, which can 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. The discussion of audit scope and objectives below outlines how we addressed specific corporate governance issues.

Background Information

Montana, in common with many other states, began developing systems for providing workers' compensation insurance coverage in the early 1900s. These systems have developed over the years to include different elements of private and public sector provision. Montana also shared the experience of many other states in undergoing a period of disruption in the 1970s and 1980s as state-run workers' compensation insurers accrued significant unfunded liabilities. For many states, the solution to this crisis was to establish publicly-chartered competitive state funds to provide some form of guaranteed market, while competing with private insurance businesses. Around 20 states including Montana currently operate with a competitive state fund providing workers' compensation insurance in a market environment.

Basic MSF Operating and Financial Information

MSF is a state agency, but is exempted from some laws applicable to agencies, operates as a business corporation and competes against roughly 470 private insurance companies providing workers' compensation coverage in Montana. The following table provides some basic operating and financial data for MSF.

Table 1
MSF Operational and Financial Information
Fiscal Year 2008

Montana State Fund Information	
Number of Policyholders	32,400
Number of Employees (FTE)	298
Number of New Claims for Benefits	15,100
Approximate Market Share	70%
Premium Income	$231 million
Investment Income	$34 million
Losses (claims) and Expenses	$242 million
Total Assets	$1.2 billion
Total Liabilities	$973 million
Net Assets	$225 million

Source: Compiled by the Legislative Audit Division from Montana State Fund records.

With nearly 33,000 policyholders, MSF services approximately 70 percent of the market for workers' compensation insurance in Montana. The business processes over 15,000 new claims of benefits (wage loss or indemnity and medical expenses) every year. Total gross income in fiscal year 2008 was approximately $265 million, versus around $242 million in expenses resulting from benefits claims and loss adjustment and administrative expenses. MSF holds almost $1.2 billion in assets and has around $973 million in total liabilities, including $752 million in unpaid claims and loss adjustment expenses, for a current policyholder surplus (equity) of $225 million. By most measures of financial strength used in the insurance industry, MSF qualifies as a financially healthy business.

Audit Scope

Audit scope was developed through the course of the audit risk assessment and planning processes. Defining audit scope using the concept of corporate governance allowed us to develop objectives addressing some key MSF business operations. Using the OECD definition of corporate governance, we identified certain elements of MSF corporate governance principles and practices for inclusion within the scope of the audit.

Audit Objectives

We developed the following audit objectives based on risk assessment work and the established scope of the project.

1. Are the legal and organizational structures of the MSF Board of Directors comparable with best practices in corporate governance?
2. Do MSF risk management activities and strategic business planning processes contribute to effective performance management for the business?
3. Are MSF policies relating to employee compensation comparable with industry standards and other best practices?
4. Have the MSF executive and employee incentive program controls been implemented effectively?

Audit Methodologies

Audit methodologies used to address our objectives involved identifying applicable standards and other criteria for corporate governance practices (both in the private sector and among other competitive state funds). Audit methodologies involved gathering and reviewing information through the following means.

- Interviews with current MSF board members addressing different governance issues.
- Interviews with the MSF executive management team and other employees.
- Interviews with staff in other state agencies, including the Department of Labor and Industry and the State Auditor's Office.
- Review of statutes from Montana and other states addressing state fund governance.
- Review of MSF internal policies and procedures.
- Review of information and documents relating to the strategic business planning process.
- Observation of MSF board meetings and review of agendas and minutes from previous board meetings.
- Analysis of SABHRS human resource data for MSF and other state agencies.
- Analysis of MSF human resources data relating to employee performance and executive and employee incentive programs.

Data Limitation

During audit work, we requested access to comparative salary data and analysis from a compensation consultant contracted by MSF. The contractor declined our request, citing the confidential nature of comparative salary data provided by other clients and businesses providing such information. Protection of proprietary salary survey data appears to be a prevalent practice among compensation consultants. Compensation consultants rely on their ability to access confidential salary records from different businesses and confidentiality guarantees are likely necessary in many cases. Our inability to access the salary survey data forming the basis of the MSF executive and employee pay plans constitutes a data limitation, which we must disclose under government auditing standards.

Application of Corporate Governance Best Practices and Standards

Corporate governance issues have received heightened levels of scrutiny over recent years in response to various high-profile business failures. Passage of the federal Sarbanes-Oxley Act in 2002 has also focused the attention of corporate America on governance standards. In applying corporate governance standards we are recognizing that although MSF is legally a state agency, Montana law establishes the agency as a corporate entity and expressly defines its mission as a business competing in the private market place. Likewise, MSF executive management and its board have adopted various private sector corporate practices and oriented the business towards the highest standards of practice adopted in the insurance industry. Consequently, we have chosen to apply many corporate governance standards applicable to large business organizations to MSF, while remaining cognizant that not all these standards will be appropriate to Montana's specific circumstances.

The following lists some of the organizations and groups we identified as sources for best practices and other standards for corporate governance.

- Business Roundtable Institute on Corporate Ethics
- California Public Employees' Retirement System
- Casualty Actuary Society
- Committee of Sponsoring Organizations of the Treadway Commission
- Chartered Financial Analysts' Center for Financial Markets Integrity
- Committee for Economic Development
- Council of Institutional Investors
- Deloitte & Touche / Society of Corporate Secretaries and Governance Professionals
- Enhanced Business Reporting Consortium
- Government Accountability Office
- Institute of Internal Auditors
- International Federation of Accountants
- New York Stock Exchange

- Organization for Economic Cooperation and Development
- PriceWaterhouse Coopers
- Risk Metrics group
- Society for Human Resource Management
- Teachers' Insurance and Annuity Association – College Retirement Equities Fund
- United States House of Representatives Committee on Oversight and Government Reform

Report Organization

The remainder of this report includes chapters addressing each of our audit objectives, which are summarized as follows:

- Chapter II addresses the composition and structure of the MSF board as discussed under our first audit objective.
- Chapter III includes assessment of MSF risk management and strategic business planning process as addressed in our second audit objective.
- Chapter IV provides analysis of MSF compensation policies as discussed in our third audit objective.
- Chapter V addresses MSF executive and employee incentive programs discussed in our fourth audit objective.

Chapter II – Composition and Structure of The Board of Directors

Introduction

In corporate entities, governance responsibilities are generally vested in a board of directors or similar body operating with some degree of independence from executive management. Governance boards represent the interests of stakeholders in the business and perform oversight functions to ensure executive management discharges its responsibilities. The board holds executive management accountable for business performance, but should not be involved in day-to-day management decisions. Our first audit objective involved addressing the governance structure of the Montana State Fund (MSF) Board of Directors (the board).

Statutory Role and Responsibilities of the Board

This standard corporate governance approach is reflected in statutes outlining the composition, structure and duties of the MSF board. Section 39-71-2315, MCA, states, "The management and control of the state fund is vested solely in the board." The board is also assigned specific responsibilities, which include adopting a business plan for each fiscal year and publishing an annual report; approving expenditure of funds for scholarship, educational and charitable purposes; appointing and compensating the MSF Chief Executive Officer; declaring policyholder dividends; establishing insurance rates and engaging the services of an independent actuary to develop and recommend actuarially sound rates; and approving an annual operating budget for MSF.

In addition to these specific responsibilities, the governance structure of the MSF board is also outlined in section 2-15-1019, MCA, establishing the board and defining its composition. These aspects are discussed in the sections below, which focus on how the MSF governance structure compares with other state funds and with general corporate governance standards.

Comparison of MSF Board Structure and Other State Funds

Part of our best practices review of MSF governance structures involved comparison between Montana's board structure and those in other states. Comparison with other states was restricted to a selection of states operating competitive state workers' compensation insurance funds (state funds). We selected ten other state funds to include in our comparison based on their degree of similarity with Montana's workers' compensation system. The ten other state funds included are listed as follows:

- Arizona - State Compensation Fund
- Colorado - Pinnacol Assurance
- Idaho - State Insurance Fund
- Kentucky - Kentucky Employers' Mutual Insurance Authority
- Louisiana – Louisiana Workers' Compensation Corporation
- New Mexico - New Mexico Mutual Casualty Company
- Oklahoma - CompSource Oklahoma
- Oregon – State Accident Insurance Fund Corporation
- Rhode Island - The Beacon Mutual Insurance Company
- Utah - Workers' Compensation Fund of Utah

Review of governance structures involved identifying applicable statutory and rule-based requirements and gathering other information on the composition, structure and role of the board of directors for each organization.

Review of Governance Practices in Other States

Although every state fund is, to some extent, the product of unique circumstances, there are also some broad similarities evident in their governance structures. The following table summarizes information comparing board composition, structure and other governance elements in the states we reviewed.

Table 2
Statutory Governance Structures for Selected Competitive State Funds

State Fund	Number of Members	Member Appointment Method	Background & Expertise	Management Membership	Selection of Chair
Arizona	5	Governor	Policyholder	None	Governor
Colorado	9	Governor	Policyholder/ Insurance/ Finance	None	Board
Idaho	5	Governor	Insurance/ Business/ Labor/ Legislative	None	Governor
Kentucky	10	Governor/ Agency	Public	None	Board
Louisiana	12	Governor/ Agency/ Legislature/ Election	Policyholder/ Business/ Labor/ Insurance	None	Board
Montana	7	Governor	Policyholder/ Insurance	CEO (ex officio)	Governor
New Mexico	9	Governor/ Election	Policyholder/ Finance	CEO (voting)	Board
Oklahoma	9	Governor/ Agency/ Legislature	Employers/ Employees	None	Board
Oregon	5	Governor	Policyholder/ Public	None	Board
Rhode Island	9	Governor/ Election	Policyholder	CEO (ex officio)	Board
Utah	7	Governor/ Agency	Policyholder/ Finance	CEO (voting)	Board

Source: Compiled by the Legislative Audit Division from state statutes and state fund records.

The five main governance features included in this table are the number of board members, the method of appointment of members, the backgrounds and/or representative interests of members, the presence of executive management on the board, and the process for appointing the board chair. Each of these features is discussed below.

- **Numbers of members** – state funds have between 5 and 12 board members. This range is consistent with general corporate governance standards, which suggest boards require at least five members, but no more than 12-15 in total. The MSF board has seven members, which is consistent with overall trends
- **Member Appointment Method** – all state funds have a role for the Governor in appointing members, but some funds also provide for other methods. Of particular interest from a corporate governance perspective, Louisiana, New Mexico, and Rhode Island provide for election of board members by policyholders. This approach puts these funds closer to governance standards for

large business organizations, which emphasize election of directors by stakeholders. Montana currently has a less diverse range of board appointment methods and maintains sole gubernatorial authority.

- **Background and expertise** – common representative interests on state fund boards include policyholders, business or organized labor groups, insurance industry, or the general public. Three boards (Colorado, New Mexico, and Utah) require a member or members to have specific expertise in financial issues. This mirrors general corporate governance standards emphasizing the need for financial expertise on boards. Montana statute currently allows for insurance industry representation on the MSF board, but does not require any specific financial or accounting expertise among board members.
- **Management membership** – three of the state fund boards in our review allow executive management membership on the board (similar to Montana). The other funds do not have management membership on the board. Corporate governance standards increasingly emphasize the need to maintain a balance between executive and nonexecutive membership to ensure the board can act independently. MSF would appear to meet this standard because although the CEO sits on the board, he or she is an ex officio member and cannot vote.
- **Appointment of chair** – statutes for eight of the ten state funds we reviewed provide for election of the board chair by the membership. The MSF board chair is appointed by the Governor. Direct election of the board chair by the membership on an annual basis is a common governance standard applied in large business organizations. The ability of the board to annually select its own leadership and provide feedback on the performance of the chair is an important element in developing governance independence and accountability.

Statutory Authority Grants Wider Autonomy to Boards in Some Other States

Overall, the composition of the MSF board meets many corporate governance standards. Most importantly, MSF board members are, by definition, independent of executive management as far as the appointment process is concerned. Montana's governance approach provides for a board that can function independently of management and although the MSF CEO sits on the board, this position is not accorded voting status.

The main difference between the MSF board and the boards of the other state funds we reviewed is the degree to which corporate governance principles promoting independence and accountability are applied. Development of corporate governance standards in the private sector increasingly focuses on standard practices such as direct election of some or all of the board members, requiring certain types of expertise on financial matters, limiting the presence of executive management on boards, and providing for the election of the board chair by the membership. Although some states have implemented some of these standards for state fund boards, adoption of these more stringent corporate governance standards has not been uniform. Currently, the structure of the MSF board meets the minimum corporate governance standards and ensures the board is organized in a manner that provides for functional independence from executive management.

Conclusion

The structure of the Montana State Fund Board of Directors meets minimum corporate governance standards and provides for functional independence from executive management.

Review of Governance Structure Identified Two Areas for Improvement

Our review of corporate governance principles also identified two specific areas for improvement between governance practices for MSF and prevailing standards. These two issues are summarized as follows and discussed in the sections below.

- Use of committee structures by corporate boards
- MSF board interactions with regulatory agencies

Committee Structures for Corporate Boards

A first area for improvement we identified in reviewing corporate governance practices for the MSF board was the use of committee structures. The board does not use a committee structure and reviews information, deliberates issues, and conducts business with the full board membership.

Board Committee Structures are a Common Governance Practice

All identified corporate governance standards for large business organizations identify the use of committee structures by boards as being a best practice. For example, rules for traded companies require establishment of board committees in at least three areas; audit, compensation, and governance. Numerous standard-setting and professional business organizations point to committee structures as an effective means of organizing the work of governance entities and allowing directors to develop specific expertise in certain areas of the business.

Several examples from within Montana state government and among competitive workers' compensation funds in other states also point to board committee structures as a best practice. The Montana Board of Investments currently uses several different committees to assist its board in direction of the state's financial investment activities. Several other state funds included in our selection of peer businesses also use committee structures (examples include: New Mexico Mutual Casualty Company, the Oregon State Accident Insurance Fund, CompSource Oklahoma, and the Utah Workers' Compensation Fund).

Board Committees May Allow for More In-Depth Review

Best practices advice suggests using committees allows smaller groups of board members more time to familiarize themselves with specific aspects of the business. Greater exposure to specific issues allows board members to develop greater levels of expertise relative to certain aspects of the business. A higher level of expertise in specific areas improves the ability of board members to exercise effective independent direction of the business and should, over time, make them less reliant on the support of executive management.

Currently, MSF board members deliberate as a single group and all board business is conducted by all seven members. This may limit the ability of board members to develop in-depth expertise in governance issues, which, as a citizen board, they may not be familiar with. As MSF has grown its business, the board has and will in the future be required to deal with increasingly complex issues. While MSF may not have needed separate board committees in the past, this is likely to become a requirement as the business continues to develop. Several board members we interviewed as part of the audit thought use of committees should be considered to help the board manage it's business.

MSF Should Develop a Board Committee Structure

MSF should work with its board to identify areas of the business where board committees could be chartered to provide in-depth review. Best practices suggest several different options should be considered. At a minimum, development of an audit committee charter should be considered as this is one of the central governance responsibilities for corporate boards. Depending on the assessment of executive management and the needs of the MSF board, consideration could also be given to a compensation committee to address issues relating to compensation policies.

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.

MSF Board Interactions With Regulatory Agencies

All ten of the other state funds we selected for review are subject to some form of regulatory supervision through the state insurance commissioner or a similar office charged with regulation of insurance providers. MSF is not subject to regulation by Montana's insurance commissioner through the State Auditor's Office (SAO) as all other domiciled insurance companies in the state are, although MSF is subject to various forms of oversight. Statute addresses oversight of the MSF insurance business by assigning the legislature various means of monitoring MSF activities.

Legislative Oversight Mechanisms

Several different forms of oversight of MSF activities are performed by various legislative committees on an ongoing basis. The main oversight mechanisms are discussed as follows:

- Issues relating to workers' compensation insurance are subject to oversight through the legislature's economic affairs interim committee. Two members of this committee are also assigned as legislative liaisons to the MSF board. The legislative liaisons are not board members, but receive all the information provided to the board during meetings.
- MSF is required to provide its budget as approved by the board to the Legislative Finance Committee for review purposes. MSF is also required to provide an annual financial report to both the governor and the legislature.
- MSF is subject to annual financial audits conducted by the Legislative Audit Division and can also be subject to performance audits at the request of the Legislative Audit Committee. The Legislative Auditor is also required to conduct an annual review of MSF rates to determine whether they are excessive, inadequate or unfairly discriminatory.

Legislative Oversight is Different From Regulatory Supervision

MSF is subject to oversight by the legislature and its activities are open to public scrutiny. However, the legislature's oversight activities are limited to those that are normally conducted for state agencies and do not, by themselves, constitute a system of regulatory supervision. There are significant differences between regulatory approaches in Montana and the other states we reviewed. Although section 39-71-2315 (2), MCA, grants the MSF board powers and authority equivalent to those of a private mutual insurance carrier, the fund is not subject to the same type of regulatory supervision. The other competitive state funds we reviewed are subject to at least some of the same regulatory supervision that applies to private insurance companies operating in their states.

Under a system of regulatory supervision, insurers are subject to specialized reviews by organizations with appropriate subject matter expertise. These reviews are generally based on pre-defined standards or requirements established by the National Association of Insurance Commissioners or other appropriate organizations. The goal of regulatory supervision is promoting adherence to standards and requirements in day-to-day business operations and this generally involves giving the regulatory agency enforcement authority in some form. Legislative oversight of MSF does not meet these parameters. Neither the legislature nor its component committees or staff divisions have appropriate subject matter expertise relative to insurance regulation. The legislature does not have any defined procedures in place to act in a regulatory capacity (this is generally held to be a responsibility of the executive branch of government). In addition, the legislature and its component units do not have any specific enforcement authority. As with all areas of public policy, the legislature retains the ability to enforce regulation through legislation, but this approach may not provide an appropriate forum for enforcement action.

Corporate Governance Standards for Regulatory Interactions

In its principles of corporate governance, the Organization for Economic Cooperation and Development (OECD) identifies clarity in regulatory oversight as part of the basis for effective corporate governance. These principles state in part "Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner." Effective regulatory supervision is important for corporate governance because regulators act in a way that provides boards with an independent, external assessment of issues relating to legal compliance and sound business practices as compared with defined standards and requirements.

Most organizations developing corporate governance standards emphasize a role for the board in assessing the business's compliance with applicable laws and regulations. The current regulatory approach for MSF does provide for a means to assess compliance with state law in general (through audits and other reporting mechanisms), but specifically exempts MSF from the laws applicable to an insurance business. The board is able to access external advice from its consulting actuary and from rate advisory groups such as the National Council for Compensation Insurance, but these organizations provide services and advice, not regulatory supervision. The board currently acts in a self-regulatory capacity as regards MSF insurance operations and, therefore, assumes a greater burden of legal compliance risk than is the case for peer businesses.

Lack of Regulation and MSF Market Dominance May Diminish the Effectiveness of Governance Practices

As stated previously, specific and unique circumstances have often dictated the development of governance practices for state funds around the country. Although there is a clear variance between the regulatory basis under which MSF operates versus its business peers, there do not appear to have been any identifiable negative effects to date.

It is an open question whether this is likely to change if MSF continues to consolidate its current market dominance in the state. Analysis conducted by the SAO already shows Montana's market for workers' compensation insurance is highly concentrated. The position of market concentration currently held by MSF could be viewed as increasing the level of risk to which the board is subject as a governance entity.

Conclusion

The Montana State Fund Board of Directors currently functions without regulatory supervision of Montana State Fund insurance operations. This may increase the legal compliance risks to which the board is subject as a governance entity.

Chapter III – Risk Management and Business Planning

Introduction

Montana State Fund (MSF) operates as a business and managing risk is a fundamental part of its mission. Risk can be generally defined to include both negative events affecting business performance, and the ability to realize benefits from positive events or opportunities. As a corporate governance issue, risk focuses on the role of governance entities in providing oversight of executive management risk management practices and developing an awareness of the significant risks facing the organization. Our review of risk management activities at MSF addressed the role of the Board of Directors (the board) in overseeing executive management risk management practices.

Risk Management and the Board

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a group of accounting, auditing, and other management organizations that has developed guidance and standards for risk management. COSO defines the concept of risk management to encompass multiple processes across all levels of an organization. Methodologies conducted under our second audit objective were not designed to provide a comprehensive review of MSF risk management practices, but to concentrate on the governance role of the board. This includes the board's awareness of the business's risk exposures, and its ability to provide effective oversight of executive management risk mitigation activities.

Strategic Business Planning as a Risk Management Activity

We also focused our assessment of risk management activities on the development of the MSF strategic business plan. This is partly because the COSO risk management framework is oriented towards achieving strategic objectives. Another reason for focusing on strategic planning relates to the specific role established for the board under state law. Under section 39-71-2315(3), MCA, the MSF board is required to adopt an annual business plan, including goals for financial and operating performance.

The following sections summarize audit work and discuss findings relating to the role of the MSF board in enterprise risk management, MSF internal auditing functions, the strategic business planning process, and the use of operating performance data.

MSF Board Risk Management Role

Our review of the risk management practices of the MSF board involved interviewing board members, examining MSF policies and internal documents relating to risk management, and observing board meetings and reviewing board meetings minutes and other documentation. We also reviewed the available statutory guidance relative to the role of the MSF board in managing risk.

Statute Partly Defines MSF Board Duties

As discussed in the preceding chapter, much of the basis for the corporate governance practices employed by MSF is found in statute. Unlike most private enterprises, state law imposes certain requirements on the MSF board, which outline its governance role and partly constitute a risk management framework. Examples of state legal requirements that form part of a risk management framework are discussed as follows.

- § 39-71-2315(3), MCA, requires the board to adopt an annual business plan, including performance management data.
- § 39-71-2315(5), MCA, requires the board to publicly disclose business plan performance.
- § 39-71-2317, MCA, gives the board authority over the appointment of the Chief Executive Officer (CEO).
- § 39-71-2330, MCA, grants the board authority to set rates and determine surplus.
- § 39-71-2363(2)(a), MCA, requires board approval of the MSF operating budget and also requires annual financial reporting to the Governor and legislature.

MSF has also developed various policies and conducts various activities beyond what is required in statute that also ensure risks are managed effectively. As an example, MSF has developed a comprehensive code of conduct applicable to all its staff and operations, which provides guidance relating to integrity and ethical conduct, confidentiality, accountability, conflicts of interest, and disclosure requirements.

Board Awareness of Significant Business Risks

Review of MSF board meeting minutes for the past two fiscal years also confirmed an organizational commitment to effective risk management. Review of minutes and related documents for all board meetings taking place during fiscal years 2007 and 2008 showed the board receives all the reports and data required under state law, and also takes appropriate action relative to its approval authority for certain business decisions. MSF executive management regularly supplies its board with timely financial and operating information, including business plan performance data, quarterly financial reports, annual surplus and reserve reports, budget variance reports, and rating and classification analyses.

Interviews with board members also confirmed that the current membership is generally comfortable with the business's risk exposures. The majority of the board members we interviewed were confident that MSF executive management provides them with sufficient and timely information on significant business risks. Most of the board members also expressed the view that the board's assessment of significant business risks is broadly similar to that of executive management.

Conclusion

Implementation of statutory requirements and effective communication of information by executive management improves the ability of the Montana State Fund Board of Directors to provide effective oversight or risk management.

Role of the Internal Audit Function

MSF has an internal audit function and currently employs a single FTE to fulfill these functions. The MSF Internal Auditor is organizationally attached to the executive offices and reports directly to the CEO. During interviews, several board members suggested there could be more direct involvement for the board in directing MSF internal auditing. Although the Internal Auditor attends board meetings and updates board members on activities, there is a limited direct reporting relationship between the board and the Internal Auditor, and the board's involvement in identifying and prioritizing the work of the Internal Auditor is limited.

Best Practices Suggest Joint Reporting for Internal Audit Functions

The Institute of Internal Auditors (IIA) is an organization representing members of the internal auditing profession that has developed standards for the professional practice of internal auditing, which serve as general best practices guidance for internal auditing activities. These standards emphasize joint reporting and communication between internal audit functions and both the CEO and the board of directors. IIA standards encourage a direct role for the board in reviewing external assessments of internal audit functions, providing input on annual work or activity plans, communication and approval of auditing activities and resource requests, reporting on significant governance issues within the organization, and receiving and reviewing internal audit reports and other reporting products produced by the internal audit function.

Strengthening Links Between Internal Audit and the Board

As currently structured, the relationship between the MSF board and the internal audit function is less direct than identified best practices suggests it should be. The board currently has limited opportunities for directly controlling planned internal audit activities and reviewing resulting reports. This situation could allow executive management too much control over the scope and nature of internal auditing activities at MSF and potentially jeopardizes the independence of the internal audit function and the ability of the board to exercise effective oversight of MSF risk management practices.

The MSF Internal Audit Charter outlines the responsibilities of the Internal Auditor, and the role and responsibilities of the internal audit function. The charter defines the reporting relationship between the Internal Audit position and the CEO primarily. References to the board are limited to providing for access to board members by the Internal Auditor. The charter does not provide for a direct role for the board in reviewing work plans/activities, reviewing audit reports, or otherwise providing input on the governance role of internal audit functions. Revising the Internal Audit Charter to provide for a more direct reporting relationship between the board and the Internal Auditor could strengthen the board's ability to provide effective oversight of risk management activities. These changes should supplement rather than replace the current reporting relationship between the CEO and the Internal Auditor.

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.

Business Planning

MSF uses a business planning process to help the business progress towards defined goals and objectives. As stated above, the MSF board is required to adopt an annual business plan under section 39-71-2315, MCA, and the process of reviewing and approving the business plan is an important part of the overall risk management framework. Reviewing business strategy and monitoring achievement of goals and objectives is also a key corporate governance practice for large business organizations.

Description of MSF Business Planning Process

The business planning process is conducted annually on a fiscal year basis. The MSF board adopts the plan no later than June 30 for the next fiscal year and also holds a public meeting to review plan performance between July 1 and October 31 of each year. The business plan includes specific financial and operational performance goals that allow for an assessment of the performance of the fund over the year.

The business planning process is administered by MSF under the Vice President for Corporate Support and activities are coordinated through a Strategic Program Coordinator position (1 FTE). Business planning, under ideal conditions, is a cyclical and ongoing activity that involves continual monitoring and adjustment. Several elements of the MSF planning process can be identified as contributing to its effectiveness:

- The business planning process is cyclical and administered on a regular schedule. MSF compiles plans every year and maintains consistency in the timeframes used for implementing strategic initiatives and reporting results.
- The business planning process is inclusive and allows opportunities for input at every level of the business. MSF has recently begun using direct input from all employees during the process of developing the business plan. Involvement also extends through executive management to the board.
- The business planning process includes use of performance measurement techniques, including identification of measures and establishment of targeted levels of performance.
- The business plan is used throughout the year and progress towards defined goals is assessed at least quarterly. The monitoring process is not restricted to executive management, information on plan performance is shared regularly with both MSF employees and the board.
- The business plan is subject to public scrutiny and governance oversight through the board. MSF makes full disclosure of its business strategies and associated performance targets in public meetings of the board and makes the plan available via its website.

Analysis of Business Plan Performance Data

The performance measurement component of the business plan consists of six Key Success Measures used by MSF as the basis for assessing progress towards strategic goals. These measures are shown in the following table.

Table 3
Montana State Fund Strategic Business Plan Key Success Measures

Key Success Measure	Measure Type	Measure Value	Description
Net Operating Income	Quantitative	Dollar ($)	Base measure of profitability. Value expresses the difference between MSF income (premiums and investment returns), and expenses (paid benefits, and loss adjustment and administrative expenses).
Net Earned Premium	Quantitative	Dollar ($)	Value of premium income generated by MSF during a fiscal year to cover overhead and operating expenses.
Fiscal Year Loss Ratio	Quantitative	Percent (%)	Proportion of earned premium used to pay losses incurred by the business. Used as an indicator of underwriting profitability.
Expense Ratio	Quantitative	Percent (%)	Proportion of earned premium used to pay MSF operating/administrative expenses (exclusive of losses incurred through payments of claims).
Investment Income	Quantitative	Dollar ($)	Value of returns on invested assets. Assets (including reserves and equity) are invested to generate income. The MSF investment portfolio is managed by the Board of Investments.
Enterprise-Wide Initiatives	Qualitative	Output/ Activity	Qualitative measure of successful implementation of strategic initiatives focused on different parts of the business or specific projects. Success is defined by completion of initiatives.

Source: Compiled by the Legislative Audit Division from Montana State Fund records.

Review of financial and other types of performance reporting for other competitive state funds shows MSF is using performance measures that are commonly applied to this type of business. As with any business process, there are multiple indicators or metrics that can be used to measure performance. This is particularly true for the insurance business, where the collection and analysis of data (financial and operational) is a core management duty. While MSF could, and has in the past, used a variety of different performance measures in the business planning process, the current selection of Key Success Measures based on financial reporting appear to be appropriate for the purposes of measuring performance.

Conclusion

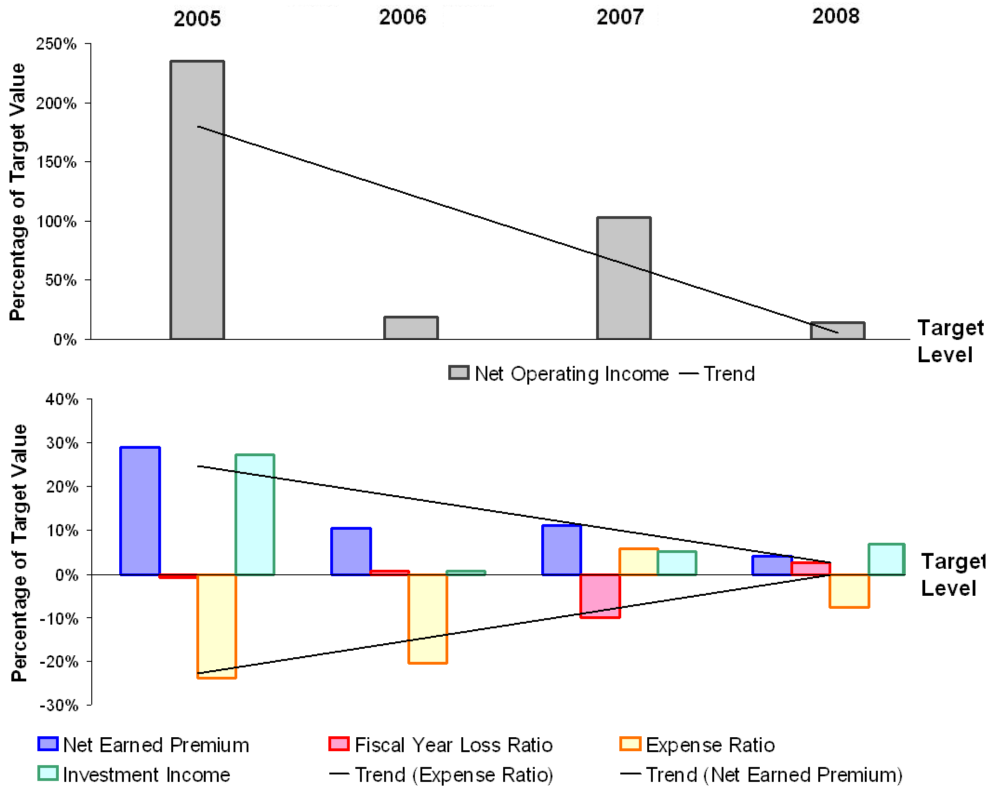
The Montana State Fund business planning process uses performance measures consistent with best practices.

MSF Demonstrates Commitment to Consistency in Measuring Financial Performance

The Key Success Measures being used for the current business planning cycle have been in place for the past four fiscal year periods. Every year, the business planning process includes establishing a targeted level of performance. These targets are documented in the plan and are subject to the review and approval of the board. Along with selecting the right measures, establishing realistic yet challenging performance targets is important to a successful strategic planning process. Performance targets need to be challenging enough to motivate staff and recognize superior effort, but also need to be realistically achievable.

Achieving balance between realistic, but challenging, targets is a difficult process and generally requires a consistent approach coupled with rigorous analysis of performance trends. To determine how well MSF performs in setting performance targets in the business planning process we reviewed targeted versus actual performance for the Key Success Measures used in the past four planning cycles. The following figure shows the percentage difference (plus or minus) between the target established by MSF and the actual results achieved for net operating income (top chart) and the four remaining quantitative measures (bottom chart). The charts also include trend lines showing how close MSF is moving towards its targets for selected measures.

Figure 1
Strategic Business Plan Performance Targets
Fiscal Years 2005 – 2008



Source: Compiled by the Legislative Audit Division from Montana State Fund records.

As shown, net operating income results deviated widely from the performance targets in 2005 and 2007, but have shown increasing stability over the four-year period. Fluctuations for the other four measures have also decreased over the period of study, down to a range of +/- 10 percent. Overall, this analysis shows there have been improvements over the past four cycles in target accuracy. No performance measurement target can (or should) ever be absolutely accurate; real-world results will always produce some deviation from expectations, but reducing deviations to an acceptable range indicates the planning process is establishing realistic targets.

MSF Planning Process Meets or Exceeds Standards

MSF has implemented a business planning process that meets or exceeds many applicable standards. MSF has taken a broad-based and inclusive approach to developing its business plans. The plans developed over recent years have used financial performance goals as required under section 39-71-2315(3)(a), MCA, and the performance targets established in the plans have become increasingly reliable indicators of expected results.

Most importantly, the MSF business planning process is subject to independent review and approval through the board and, as a public document, is subject to general public disclosure. From a corporate governance perspective, this kind of internal and external scrutiny ensures executive management is held accountable for business performance.

CONCLUSION

The Montana State Fund business planning process functions as an effective means of ensuring executive management is accountable for business performance.

Qualitative Performance Indicators Lack Defined Expectations

One area where the business planning process could be strengthened relates to the Key Success Measure addressing implementation of enterprise-wide initiatives. The first five measures used by MSF are derived from financial reporting data and are quantitative in nature. Achievement of enterprise-wide initiatives is a qualitative measure and the associated initiatives are assessed on the basis of project-specific deliverables, rather than any defined expectations regarding overall outcomes.

Although the board and other MSF stakeholders are provided defined expectations and quantifiable performance measurement data relating to the business's financial results, there are limited corresponding expectations and data available for qualitative measurement of success. The annual strategic plan does not provide metrics or data allowing users to determine whether enterprise-wide initiatives have resulted in measurable improvements in overall outcomes. As an example, over recent years MSF has focused on workforce initiatives designed to improve engagement with employees, but strategic plans have not included a means of assessing whether these initiatives have resulted in lower turnover, increased employee morale or enhanced productivity. Another example would be safety programs. Over recent years MSF has focused on improving safety services to policyholders in attempts to control losses. The effects of initiatives addressing safety programs might be measurable through analysis of trends in claims frequency or severity for different groups of policyholders, but the business plan has not established expectations for performance in these areas.

Under section 39-71-2315(3)(b), MCA, the MSF board is required to adopt a business plan that includes "specific goals for the fiscal year for operating performance. Goals must include but not be limited to specific performance standards for staff in the area of senior management, underwriting, and claims administration." This is in addition to specific financial performance goals required under section 39-71-2315(3)(a), MCA.

Although there is no simple division between financial and operational data, statute does make a distinction that suggests use of quantitative data should be balanced with qualitative measures of success (including specific performance expectations).

MSF Already Has a Good Basis for Defining Expectations Regarding Enterprise-Wide Initiatives

Identified best practices advice and other standards relating to performance measurement emphasize the need for a balanced approach to evaluating business performance. This should include both financial and nonfinancial perspectives (something that MSF already acknowledges in its current approach to business planning). Appropriate measurement of nonfinancial indicators can involve looking at many different kinds of data, depending on the type of business. MSF already periodically collects and analyzes qualitative performance data from different sources, including the following.

- Customer satisfaction surveys
- Employee satisfaction/engagement surveys
- Staff turnover, absenteeism and other human resource data
- Claims severity and frequency data
- Process efficiency or productivity monitoring

MSF management already tracks many of these data elements or has the ability to perform analysis to identify problematic operational issues. However, the current business planning process does not necessarily include continuous assessment of qualitative measures or define specific expectations regarding acceptable or unacceptable performance. MSF management is correct in highlighting the fact that performance in many operational areas will have a corresponding effect on financial results, but this evidence may not be immediate.

Use of NonFinancial Performance Measures Provides Long-Term Perspective

Without defined expectations and ongoing reporting of nonfinancial performance metrics, the board and other MSF stakeholders receive limited information on the long-term drivers of business value and may not be able to identify and react to adverse developments in proactive manner. Although MSF should certainly continue to emphasize consistency and stability in reporting performance data, identification and inclusion of some specific nonfinancial performance metrics could provide additional context for stakeholders reviewing business performance. Identifying appropriate measurements and establishing defined expectations regarding performance could assist the board and other stakeholders reviewing MSF business strategies. This approach could also assist MSF management in their efforts to manage the business proactively and promote accountability to stakeholders.

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.

Chapter IV – Compensation Policies

Introduction

In a business environment, compensation policy is a key factor in creating value. Effective compensation policies allow businesses to recruit and retain a qualified workforce and reward performance that adds value. Montana State Fund (MSF) employees are state employees, but the corporate mission of the organization has led to certain exceptions being made regarding compensation policies. MSF operates its own employee pay plan, separately from other agencies within state government. MSF has also been authorized to develop its own system for administering employees' personal leave. The MSF Board of Directors (the board) is responsible for hiring and compensating the Chief Executive Officer (CEO) who serves at the pleasure of the board. The CEO is given discretion in hiring management staff, which are exempt employees and serve at the pleasure of the CEO.

Compensation as a Corporate Governance Issue

Compensation policies have received increasing amounts of attention over recent years as a corporate governance issue. This has been particularly true for CEO and other executive compensation. The compensation philosophies of major corporations have increasingly focused on rewarding executive management and linking compensation policies with business performance. The California Public Employees' Retirement System (CalPERS) is one of the country's largest institutional shareowners and is frequently cited as an authority on corporate governance standards. CalPERS principles of accountable corporate governance described the importance of compensation policies as follows.

> "Compensation programs are one of the most powerful tools available to the company to attract, retain, and motivate key employees to optimize operating performance, profitability and sustainable long-term shareowner return. Well-designed compensation programs will be adequately disclosed and align management with the long-term economic interests of shareowners."

Audit Methodologies Addressing Compensation Policies

Our audit objective relative to compensation was to determine whether MSF compensation policies are comparable with industry standards and other best practices. To address our objective, we conducted audit work in the following areas:

- Analysis of MSF compensation data and comparison with other state agencies.
- Identification and review of corporate governance best practices for executive compensation.
- Review of the role of compensation consultants in development of MSF compensation policies.

Analysis of MSF Employee Pay Plan

The MSF employee pay plan is one of roughly ten pay plans covering state employees in different branches of government. As a baseline comparison, we chose to analyze compensation data for MSF and other selected agencies to identify any significant differences between compensation policies. MSF has, in many respects, been ahead of many other state agencies in developing market-based pay plans that are geared towards rewarding employees for performance. However, with the widespread adoption of Pay Plan 20, many other agencies are moving in this direction. Increased use of market comparisons in setting pay ranges and providing for merit adjustments based on performance are increasingly commonplace and have, to some extent, made comparisons between MSF and other agencies more appropriate.

We selected 14 other state agencies to include in our review. Agencies were selected based on their needs for hiring employees with higher education or skills and experience levels. We also considered whether agencies conduct functions relating to financial or insurance issues, or are funded on an enterprise basis.

Description of MSF Pay Plan Design

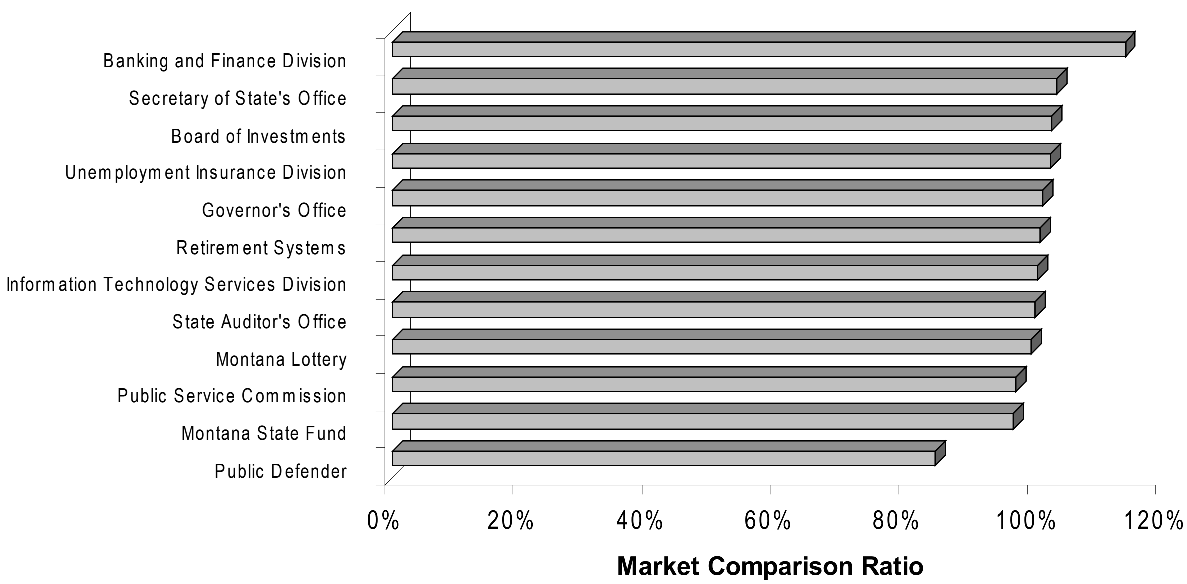
MSF is authorized to establish its own pay plan and MSF employees are exempt from certain provisions normally applicable to state employees. The MSF pay plan is designed as a market-based pay-for-performance system. This means the salary ranges for MSF positions are established based on analysis of comparable positions within the market place. It also means that MSF employees have the opportunity to receive merit-based increases in salary as a result of improvements in job performance. This type of pay plan mirrors compensation policies that have traditionally been more prevalent in the private sector and is a marked departure from traditional civil service-type pay plans used for public employees.

Market-Based Salary Comparison

The first element to address in analysis of MSF compensation policies is the market-based component. MSF engages the services of a compensation consultant to provide data and other advice on salary ranges for positions within the organization. Review of MSF human resources records shows there are approximately 100 separate positions within the organization (not including the CEO and executive management positions at the Vice-President level). Each position is assigned a salary range consisting of an entry, market and maximum point. MSF works with its compensation consultant to update position classifications and salary ranges annually (more detailed information regarding the role of the compensation consultant is provided in the following sections).

As many state agencies are moving towards market-based pay plans, we compiled and analyzed data for MSF and selected other agencies within state government to show the average market comparison ratio. The market comparison ratio is expressed as a percentage and shows whether an agency is paying, on average, more or less than the market mid-point. The agencies or divisions we included for comparative purposes were those where complete market comparison data was available via the Statewide Accounting Budget and Human Resources System (SABHRS). Results of this analysis are included in the following figure.

Figure 2
Market Comparison Ratios for Montana State Fund and Other Agencies
Fiscal Year 2008



Source: Compiled by the Legislative Audit Division from Montana State Fund and SABHRS records.

The majority of the 12 agencies we reviewed were paying salaries that were, on average, at or around 100 percent of the market or mid-point in the range. This should be expected as the goal of a market-based pay plan is to move employees towards the market salary. MSF is actually at the low end of the scale based on this comparison. The average salary at MSF was approximately 97 percent of the market mid-point. At 97 percent, it appears MSF is administering its pay plan in a similar manner as compared with other agencies.

The other aspect of a market-based salary is the actual salary paid. To determine whether salaries at MSF were comparable with those for selected other agencies, we compiled and analyzed data showing the average annual salary received by employees. This data is shown in the following table.

Table 4
Average Annual Salary for MSF Employees and Selected Other Agencies
Fiscal Year 2008

Agency	Average Salary	Percent of Group Average
Minimum	$39,406	77%
Group Average	$51,102	100%
Montana State Fund	$57,580	113%
Maximum	$67,088	131%

Source: Compiled by the Legislative Audit Division from SABHRS records.

For the agencies we selected, the average salary ranges between $39,406 and $67,088 annually and the average salary for the group as a whole is $51,102 annually. The third column of the table shows the percentage of the group average for each agency. On average, MSF employees are paid $57,580 annually or 113 percent of the average. Four other agencies included in this selection had higher average annual salaries as compared with MSF. Based on this analysis, it is reasonable to state that although MSF employees receive higher salaries than the average for a group of other agencies, MSF salaries should still be seen as within an acceptable range.

Conclusion

Although average salaries for Montana State Fund employees are higher than for some agencies in state government, they are comparable to agencies with similar needs.

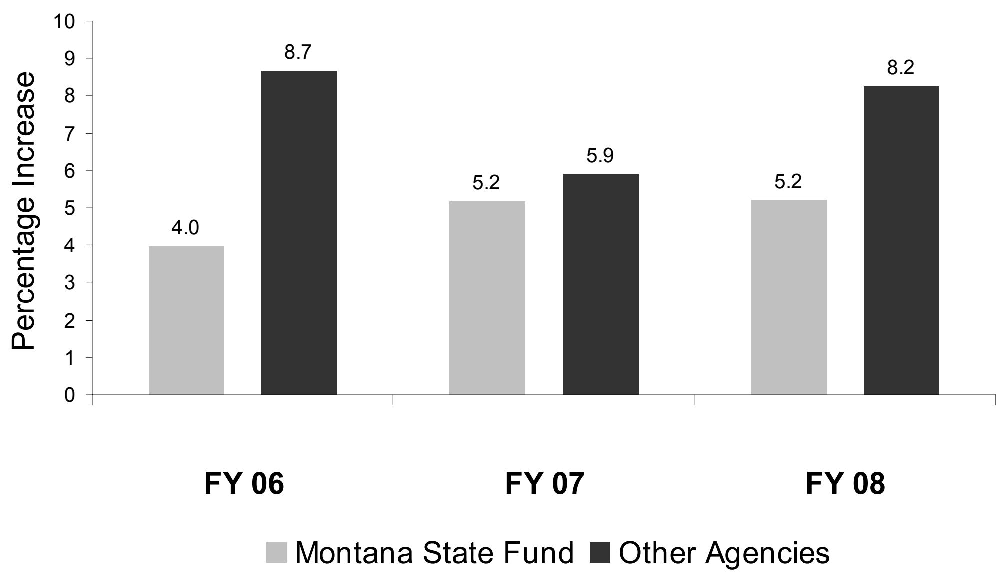
Pay-For-Performance and Merit Pay

The MSF pay plan is merit based and employees are eligible for pay increases based on job performance. MSF operates an employee evaluation/appraisal system called the Skills, Talent and Results or STAR program. Every MSF employee receives an annual evaluation through the STAR program that results in a job performance rating. Employees are eligible for merit adjustments based on these ratings. There are six rating levels, but employees receiving ratings in the bottom two categories (unacceptable or minimum-level performance) are not eligible for a merit adjustment. STAR ratings in the top four levels result in merit increases of between 2.7 percent and 6.0 percent.

Developing and implementing a structured employee evaluation system such as the STAR program should be considered a prerequisite for a merit based pay plan. Our review of MSF data and records for the STAR program shows this approach meets the Society for Human Resource Management definition of a well-administered employee evaluation system that provides a sound basis for merit adjustment decisions.

Review of merit adjustment data for MSF employees shows that the average merit adjustment was 3.6 percent in fiscal year 2006, 4.4 percent in fiscal year 2007, and 3.3 percent in fiscal year 2008. To determine whether MSF merit adjustments are in line with general trends, we reviewed SABHRS data showing annual salary increases for MSF and selected other agencies. This data included all salary adjustments, including merit increases, statutory increases, market adjustments, longevity increases, and movements within pay ranges. The following figure shows the overall annual change in base salary for MSF employees and employees of selected agencies for fiscal year 2006 through fiscal year 2008.

Figure 3
Annual Average Salary Increases for Montana State Fund and Other Agencies
FY 2006 through FY 2008



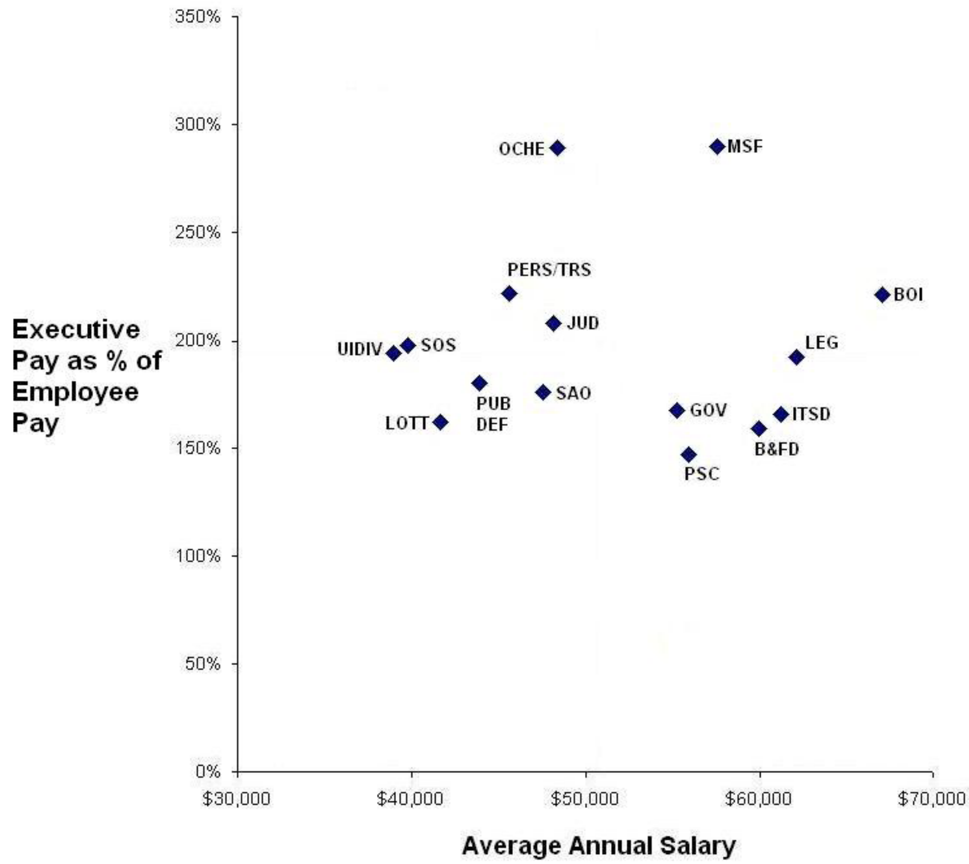
Source: Compiled by the Legislative Audit Division from SABHRS records.

Unlike the other agencies included in this review, MSF employees do not receive statutory across-the-board salary adjustments authorized by the legislature. The majority of the other employees in the other agencies shown in the figure would have received statutory cost of living adjustments of 3.5 percent in fiscal year 2006, 4.0 percent in fiscal year 2007, and 3.0 percent in fiscal year 2008. Taking these increases into account, it appears MSF salary increases over the past three fiscal years have generally been consistent with other agencies. What is apparent from this data is that merit and other adjustments made to MSF employee salaries have been relatively stable in a range of roughly 4 percent to 5 percent annually and the majority of these increases have been the result of merit adjustments based on performance.

Executive Compensation

The final part of our analysis of MSF compensation involved addressing executive compensation. While reviewing data for all MSF employees reveals a lot about the organization's compensation policies, compensation for top executives has an added significance from a corporate governance perspective. One method of addressing executive compensation is to develop a measure of internal equity based on the average compensation of the top five highest paid executives. Expressing this value as a percentage of the average salary for all employees shows how much more executives get paid as compared with 'average' employees. We performed this analysis for the top five highest paid executives at MSF and for our comparator agencies and combined the results with data for average salary. The following figure shows this analysis using an XY coordinate point for each agency, charting executive pay on the vertical axis (top five highest paid executives as a percentage of the average) and average annual salary for fiscal year 2008 on the horizontal axis.

Figure 4
Eecutive Pay and Average Salary for Montana State Fund and Other Agencies
FY 2008



Source: Compiled by the Legialative Audit Division from SABHRS records.

For MSF, the average pay of the top five highest paid executives is around 290 percent of the average salary for all employees. This puts MSF above many of the other agencies included in our review and shows that MSF pays relatively high salaries, but tends to compensate top executives at a higher rate than the rest of the group.

MSF Executive Compensation is Based on Comparative Salary Data

Some of the differences between executive compensation at MSF versus other agencies may be explained by the methods used to set salaries. As stated previously, MSF contracts with a compensation consultant to provide salary survey data used to set pay for the CEO, senior executives and many other positions. The primary comparison group used in compiling the salary survey is competitive workers' compensation state funds in other states. Because many of these other state funds are run as competitive businesses with the ability to set market-based salaries, MSF compensation levels are determined on the basis of a comparison that mirrors private sector trends more closely. In the case of the CEO, the compensation consultant provides the MSF board with a variety of salary comparisons for CEOs in other state funds. The board sets CEO compensation based on its assessment of salary ranges presented by the consultant and these ranges distinguish between different state fund structures and regional variations in compensation.

Differences Between MSF Compensation Policies and Other Agencies are Reasonable

MSF is clearly following a different compensation policy as compared with most other agencies included in our review. However, this should not be taken to mean MSF compensation policies are inappropriate. MSF has a mission and identity that is, in many ways, unique to state government. The organization's corporate identity means that there should be an expectation that some differences in compensation philosophy and policies will exist. MSF has chosen an approach where markets dictate salaries and executive staff with high potential to add value are compensated accordingly.

Conclusion

Montana State Fund has implemented compensation policies that are appropriate to its business mission.

Application of Corporate Governance Standards on Compensation Disclosure

Higher executive pay levels inevitably bring higher expectations regarding performance. These expectations increase the need for oversight of MSF executive compensation, so stakeholders can make well-informed judgments regarding performance. Meeting these oversight demands should help MSF maintain the legitimacy of its overall compensation policies.

Currently MSF does not disclose executive compensation as part of its regular reporting cycle. The absence of an annual executive compensation disclosure decreases the ability of stakeholders to readily obtain access to information that will help them determine a link between executive compensation and MSF business performance. In the past MSF has released incentive payments data and employee salaries when requested. However, these requests have been inconsistent in regards to timing and the scope of the information.

Governance Standard for Executive Compensation Disclosures

Under Section 39-71-2313, MCA, MSF is defined as a "…nonprofit, independent public corporation." In the private sector, nonprofit corporations must submit federal tax forms under Internal Revenue Code section 501(c)(3). This federal reporting includes public disclosure of executive salaries and benefits for the top five highest paid employees earning more than $50,000 a year. Nonprofits are required to disclose this information so stakeholders with a vested interest in the corporation can make educated judgments regarding the levels of executive compensation.

General best practices advice and other standards for corporate governance in large business organization suggest disclosure of executive compensation to stakeholders is an important governance standard. An example of such a disclosure is the proxy statement required for traded companies, which annually provides stakeholders with information on executive compensation and policies for publicly-listed companies. Within the proxy statement, compensation information for the top five highest paid executives is listed, along with their benefits and other forms of compensation received. An additional requirement is inclusion of a two-year history of the executive compensation. This timeframe allows stakeholders to link pay to the corporation's performance. In addition, general best practices advice for corporate governance emphasizes that executive compensation disclosure should be available to stakeholders. For example, the Council of Institutional Investors (a membership association for institutional shareholders) recommends, "all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations."

Compensation Disclosures Help Corporations Maintain Accountability

Annual executive compensation disclosures do not appear to be a practice employed by any of the other competitive state funds we reviewed, but this should not detract from their value in promoting accountability. Transparency and disclosure reduces uncertainty and may also increase the legitimacy of compensation policies. Making regular executive compensation disclosures may also alleviate some of the attention MSF receives regarding executive compensation. By making a full public disclosure, MSF may be able to help stakeholders understand its compensation policies in the context of business performance.

By implementing annual reporting on executive compensation, MSF would reinforce its position itself as a leader in the adoption of corporate governance best practices. This could also help MSF respond to criticisms regarding its compensation policies and provide an example of the organization's commitment to transparency and accountability.

In line with best practices and accepted standards of corporate governance, MSF should create and issue an annual executive compensation disclosure to its stakeholders through its annual reporting process. The disclosure should include information about the top five highest paid executive's cash and noncash compensation, MSF executive compensation policies, and should also allow for comparison between present and prior year's compensation.

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.

Role of Compensation Consultants

The practice of engaging the services of a compensation consultant to provide advice on compensation policies is increasingly crossing over from the private sector to public sector agencies. This trend is likely related to more state agencies adopting market-based salary ranges and pay-for-performance programs. Compensation consultants can provide comparative salary data on similar positions within the market, as well as other advice and services related to compensation.

External Advice on Compensation is an Important Governance Principle

MSF and its board have been using the services of a compensation consulting firm for over five years. MSF contracts with a large, multi-national consulting business with extensive experience in the field and with a specific consulting practice focused on providing services to state workers' compensation insurance funds. The consultant works under contract with MSF to provide a range of compensation advisory services, including the following:

- Review of position classifications
- Review of employee position salaries and market salary survey
- CEO compensation and incentive planning
- Vice-President compensation and incentive planning
- Executive succession planning

By itself, the use of an external compensation consultant helps MSF meet an important governance standard relative to compensation. The decision to obtain external advice on compensation, rather than rely on MSF management to compile salary data and other information, provides the board and other stakeholders with an additional level of assurance that advice will be independent and objective.

Control Systems for Compensation Consulting Services

Issues relating to the role of compensation consultants have recently been highlighted by the work of the United States House of Representatives Committee on Oversight and Government Reform. Information provided to this committee from individuals working in areas relating to corporate governance and executive compensation emphasizes the need for control structures to ensure compensation consulting services are not vulnerable to perceptions of conflict of interest. One area of concern relates to consultants providing advice on CEO and executive pay, while also generating fees for other consulting services in different parts of the business approved by executive management. Currently, the terms of the contract between MSF and its compensation consultant cover consulting services relative to both CEO/executive compensation and employee compensation. The MSF board does not have a direct role in authorizing the consulting contract for CEO compensation. Currently the CEO signs off on the contract between MSF and the contractor. This single contract covers all aspects of MSF compensation policy, across all levels of employment.

Statute Establishes Separation Between CEO and Employee Compensation

Section 39-71-2317, MCA, states, “The executive director must receive compensation as set by the board and serve at the pleasure of the board. The executive director may hire the management staff of the state fund, each of whom serves at the pleasure of the executive director.” Statute clearly establishes the discretion of the board in setting the compensation of the CEO. This division of authority between the governance entities (board) and executive management (CEO) is also reflected in general best practices advice and other standards for corporate governance. Governance standards establish that boards should have an active role in engaging the services of compensation consultants that work on CEO compensation. This would include having the consultant work directly under the authority of the board of directors, not the CEO. Contractual relationships between the MSF board and independent external advisors can also be referenced to the services of the MSF consulting actuary. The consulting actuary provides services under the terms of a contract between the Board of Directors and the contractor. The board is responsible for letting this contract, and reviewing and authorizing the terms and conditions.

Currently, MSF is vulnerable to the perception of a conflict of interest because of the role of its compensation consultant providing compensation advice for both the CEO and other employees under the same contract. Data reported by the United States House of Representatives Committee on Oversight and Government Reform shows that CEO compensation tends to be higher where companies do not enforce a separation between compensation consultants working on CEO versus employee compensation plans. This should not be taken to mean that the compensation advice provided by the MSF consultant is unreliable, but it does emphasize the need for mitigation strategies to avoid even the perception of conflict of interest. The compensation consultant contracted by MSF also contracts with a majority of other state funds around the country. A dominant market position within a relatively restricted industry subgroup could be viewed as increasing the risk of perceived conflicts, as the consultant has a role in establishing compensation policies for all the peer businesses used for comparative salary purposes.

MSF Should Address Contractual Separation of Compensation Consulting Services for CEO and Employee Pay

The board of directors should have a direct role in CEO compensation through authorization and execution of the compensation consulting contract for the purposes of providing advice on CEO compensation. MSF should maintain a clear separation between contracting for compensation consulting services for employees versus those services relating to CEO compensation. The CEO/executive management of MSF should maintain authority over contracts for compensation consulting services for all other levels of employment. This approach could mitigate the perception that some compensation consulting arrangements are subject to inherent conflicts of interest.

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.

Chapter V – Executive and Employee Incentive Programs

Introduction

Our final audit objective addressed Montana State Fund (MSF) executive and employee incentive programs. MSF has established these programs under the direction of its Board of Directors (the board) to annually provide employees with an opportunity to earn a performance-based incentive payment, in addition to their regular salary. These kinds of incentive programs have been prevalent in the private sector for some time, but are still relatively uncommon in state agencies. MSF is not the only Montana state agency making incentive or bonus payments to employees, but the MSF programs do appear to be the most comprehensive. Our audit objective was to determine whether the MSF incentive programs have been implemented effectively. To address this objective, we gathered information on the development of the programs, analyzed payments made under the programs, and evaluated MSF controls over incentive payments.

MSF Incentive Programs Modeled on Private Sector Practices

The basic design of the MSF incentive programs is based on an approach in the private sector, which is often referred to as gainsharing. These types of programs are defined as providing an opportunity to earn a structured incentive payment, rather than a bonus. The distinction between an incentive payment and a bonus payment is discussed as follows:

- An incentive is based on predefined goals/targets that are established in advance. At the end of a defined period, payment is made depending on established levels of performance and payment amounts are made according to preset levels.
- A bonus may be based on meeting certain performance expectations, but payment amounts are generally discretionary and are not known in advance.

The concept of gainsharing implies an opportunity for employees to share in business profitability. If the business does not return a profit during a defined performance period, there is nothing to share with employees and no incentive payment is made. MSF uses net operating income for the fiscal year to define profitability and the business must return a defined level of net operating income before any incentive payments are made.

Distinction Between CEO/Executive and Employee Programs

MSF administers incentive programs separately for the Chief Executive Officer (CEO), Vice-Presidents (VP), and other employees. Although all the programs follow the same broad principles, there are some differences in the way performance is assessed and payments are made. Executive staff at MSF (including the CEO) have participated in incentive programs for eight years. The incentive programs were extended to nonexecutive staff to include all MSF employees around five years ago. The analysis below covers the five-year period since fiscal year 2004, when all MSF employees became eligible to participate in the incentive programs.

Design of MSF Incentive Program

MSF incentive plans are linked to business performance through the business plan. As discussed in Chapter III, the business plan is developed annually by MSF and approved by the board. The plan helps align MSF business operations with the organization's strategic goals and objectives. MSF uses a performance management approach that involves establishing targets for business performance using certain measures of success. These Key Success Measures allow MSF to assess its performance based on predefined goals/targets, and also form the basis of the incentive programs. The incentive programs can, essentially, be seen as an extension of the business planning process that incentivize or motivate executives and employees to contribute to achieving the organization's strategic goals and objectives.

Program Participation and Administration

MSF incentive programs are administered according to established policies and procedures. The following summarizes some of the most significant aspects of program participation and administration.

- **Eligibility** – all employees with more than six months of service at MSF are eligible to participate in the programs, but employees must meet minimum performance expectations based on their Skills, Talent and Results (STAR) rating. Participation is not automatic, employees must meet certain performance expectations and other requirements before they become eligible.
- **Gate-keeper mechanism** – as discussed above, program payments are triggered by a gate-keeper mechanism, net operating income, which ensures incentives are based on business profitability. MSF must meet the net operating income level established in the business plan before any incentive payment can be determined. The gate-keeper is therefore subject to the review and approval of the board.
- **Team-based** – incentive programs are based on team performance. There are actually 14 separate plans for each of the major organizational units within MSF (including the CEO and VP plans). Although they are all triggered by

the gate-keeper, the separate programs use different measures of success to define performance and calculate payment levels. Using different measures of success ensures different functional teams are rewarded based on activities to which they specifically contributed.

- **Performance threshold** – the incentive programs are based on the targeted levels of performance established in the business plan. These targets are established based on the premise that there is an 80 percent probability of achieving the minimum or threshold performance level. This means the incentive programs will pay out in a maximum of four out of every five years (80 percent of the time).
- **Variable payment** – incentive program payments are calculated based on annual salary. MSF staff receive payments as a percentage of their total salary and these proportions increase in line with performance (three different levels of either threshold, target or outstanding performance). There is also variability between CEO, VP and employee payment proportions; higher levels of executive responsibility are rewarded with higher payments as a percentage of salary.

The following table shows the different payment levels established for CEO, VP, and employee plans for fiscal year 2008.

Table 5
Incentive Program Payment Levels
FY 2008

Program Type	Payment as Percent of Salary		
	Threshold	Target	Outstanding
President	10%	20%	30%
Executive	7.5%	15%	22.5%
All Others	5%	10%	15%

Source: Compiled by the Legislative Audit Division from Montana State Fund records.

As shown, the CEO is eligible for an incentive payment of up to 30 percent of annual salary where performance exceeds the outstanding level for every key success measure. The maximum payment for the VP program is 22.5 percent of salary, and the maximum for employees is 15 percent. The MSF incentive program process defines outstanding performance to mean a level achievable only 20 percent of the time.

CONCLUSION
The Montana State Fund executive and employee incentive programs have been designed in accordance with best practices.

More Time Could Provide Evidence of Causal Effect

Academic studies of gainsharing-type incentive programs have generally shown that there is a positive effect on employee productivity and business performance. These studies have generally been conducted in private enterprises, but there is no particular reason that results could not be replicated in the context of a public sector organization such as MSF.

Evidence of causal effect relative to the MSF incentive program could involve reviewing how different variables have responded to the availability of incentive payments for staff. The question for analysis would be the extent to which a causal relationship exists between the introduction of incentive programs and changes in dependent variables. At the present time, we do not believe there is data available over a sufficient time series to allow for a fully valid analysis of the impacts of the MSF incentive programs. Given several more years of experience, it may be possible to conduct this kind of analysis and produce meaningful conclusions regarding the causal effects of the incentive programs and whether they are positively impacting MSF business performance.

Analysis of Incentive Program Payments and Controls

Incentive payments are generally calculated in the month of October following the close of the previous fiscal year. Payments (where applicable) are made to staff in late November. Total incentive payments have ranged between $0 in fiscal year 2004 to over $1.4 million in fiscal year 2007.

Incentive Program Has Controls Systems in Place

Our review of controls over the incentive programs involved interviews with MSF staff responsible for different parts of the program, interviews with MSF board members, and review of data and information compiled by MSF relative to the programs. Overall, the design and development of the MSF incentive programs appear to meet applicable standards and best practices and MSF appears to have effective controls over program payments. Some of the salient control elements are discussed as follows.

- The MSF board reviews and approves the business plan in a public meeting, providing objective and independent scrutiny of the performance management criteria upon which the incentive programs are based. The board has the ability to alter or adjust performance measures and targets, and has recently done so to address concerns over the reliability of some data elements.

- The MSF contracted compensation consultant is involved in reviewing elements of the incentive programs and can provide advice/input to executive management and the board regarding administration of the program. This provides an element of external review, which the board can consider in addressing the program.
- MSF has developed extensive policies and procedures addressing most aspects of program administration and establishing multiple levels of review for the program. In addition, effective segregation of duties exists as calculation of incentive payments depends on sourcing data from different organizational units within MSF.
- Incentive payment amounts and processes are subject to review by the MSF Internal Auditor, who has access to the relevant data and can provide objective assessment of the accuracy and reliability of eligibility and payment amounts.

Conclusion

Montana State Fund incentive programs are an important part of the organization's compensation policies and appropriate control systems have been developed to ensure these programs are administered correctly.

Audit work did not identify any significant concerns with the procedures in place at MSF to ensure the accuracy of the payments made under the incentive programs. We did, however, identify one area where MSF could consider strengthening its policies to address an emerging corporate governance standard relative to incentive payments.

Corporate Governance Standards for Incentive Compensation

General best practice advice and other standards for corporate governance in large business organizations suggest companies should have policies in place to allow for the recovery of incentive payments made in error. Commonly referred to as clawback provisions, these polices are put in place to recapture bonus or incentive payments awarded to employees due to errors resulting from a different interpretation of accounting policies, unintentional inaccuracies, problems with data integrity or other causes.

Clawback provisions are becoming increasingly prevalent in the private sector. Changes in use of clawback provisions by large business corporation are, to some extent, being driven by the implementation of the Sarbanes Oxley Act of 2002. Section 304 of the act requires the recovery of incentive or bonus payments rewarded based on inaccurate reporting.

MSF Has Limited Ability to Recover Incentive Payments

The MSF incentive program is not currently structured to address the recovery of incentive payments made to individuals in error. MSF therefore has limited ability to recoup incentive payments given to employees because of an error. These errors could result from a different interpretation of accounting policies, unintentional inaccuracies or problems with data integrity. MSF management already has a system of controls in place which substantially reduces the risk of errors occurring in the incentive program. However, no system of controls offers a guaranteed assurance that no errors will ever occur. In the unlikely event of incentive payments being made in error, MSF has a limited basis for addressing the recovery of incentive payments because there is currently no provision in the MSF incentive program policy outlining the process for recovering incentive payments made in error.

Clawback Provisions Could Strengthen Incentive Program Controls

To address this situation, MSF could revise incentive program policies to include a clawback provision that will aid in the recovering of incentives payments made in error. As an example, MSF could develop a policy in which incentive payments made in error are recovered through a reduction in subsequent incentive payments made in future years. This could avoid the need to recover moneys directly from employees. This precautionary measure will implement a best practice in corporate governance and could help MSF avoid potential problems with incentive payments made in error.

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.

Montana State Fund

Fund's Response

MONTANA
STATEFUND

5 South Last Chance Gulch • P.O. Box 4759 • Helena, MT 59604*4759
Customer Service 1-800-332-6102 or 406-444-6500
Fraud Hotline 1-800-682-7463 (800-M-CRIME)

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LEGISLATIVE AUDIT DIV.

February 11, 2009

Ms. Tori Hunthausen
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Hunthausen:

Montana State Fund (MSF) appreciates the efforts and professional approach of the audit staff involved in this performance review of our corporate governance practices. The report contained six recommendations. Our responses to those recommendations follow. The committee will note that several recommendations have been concurred with conditionally as MSF management will need to present these to the Board of Directors for their consideration and action. MSF management will present the audit report to the Board of Directors at its May 2009 Board meeting and will work with the board in scheduling and addressing the audit recommendations.

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.
Response: MSF management conditionally concurs. Management will bring this audit recommendation to the Board of Directors for its review, analysis, discussion, and ultimate decision. The Audit Committee should understand that the additional time commitment for the board members may impact the board's ultimate decision on this recommendation. Additional factors that mitigate a comparison to other state funds are Montana's travel logistics, and the minimal compensation for board members. However, management commits to this recommendation, and if the board elects to implement separate charters, MSF management will comply.

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.
Response: MSF management conditionally concurs. Management will bring this audit recommendation to the Board of Directors for its review, analysis, discussion, and ultimate decision. MSF currently provides for a direct reporting relationship between the internal audit function and the board, but in response to the recommendation, the board may wish to revise the internal audit charter to strengthen this relationship. As is stated

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in the audit report, "These changes should supplement rather than replace the current reporting relationship between the CEO and the Internal Auditor."

Recommendation #3: We recommend 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.
Response: Concur. MSF will work towards integrating existing performance data and defined expectations more visibly into the business planning process. As noted in the report, performance in operational areas will have a corresponding effect on financial results that will not be evident immediately. That same situation would hold true for qualitative initiatives. Defined qualitative measures may not be immediately evident when implementing initiatives.

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.
Response: MSF management conditionally concurs. Management will bring this audit recommendation to the Board of Directors for its review, analysis, discussion, and ultimate decision. As MSF is a public corporation and a Montana governmental entity, MSF employee compensation is not considered confidential information and is provided when requested.

Recommendation #5: We recommend 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.
Response: MSF management conditionally concurs. Management will bring this audit recommendation to the Board of Directors for its review, analysis, discussion, and ultimate decision. Management will recommend to the board separate compensation contracts to replace the existing contract, which expires in June 2009.

Recommendation #6: We recommend 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.
Response: Concur. MSF will revise the incentive program document to incorporate clawback provision language governing recovery of incentive payments made in error.

The board, management and staff of MSF are very proud of our continued accomplishments in serving Montana businesses. We continually strive to improve our

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operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,

Laurence A. Hubbard
President/CEO

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