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Legislative Audit Bureau

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Janice Mueller
State Auditor

December 8, 2005

Mr. Jorge Gomez, Commissioner
Office of the Commissioner of Insurance
125 South Webster Street
Madison, Wisconsin 53702

Dear Commissioner Gomez:

We have completed a financial audit of the State Life Insurance Fund for the years ending December 31, 2004, 2003, and 2002. This work was performed to meet our audit requirements under s. 13.94(1)(de), Wis. Stats. Our audit opinion on the Fund's financial statements, which are prepared on the basis of accounting prescribed or permitted by the Commissioner of Insurance, was included in report 05-17.

As required by *Government Auditing Standards*, we are providing you with the auditor's report on internal control over financial reporting, compliance with laws and regulations, and other matters. We identified a material weakness related to the Fund's financial reporting of investments. In addition, we report concerns because the Fund's surplus-to-assets ratio of 2.68 percent as of December 31, 2004, was below the statutory guideline of a minimum of 7.0 percent. We discuss other accounting errors and concerns related to the reconciliation of cash transactions recorded on the Fund's accounting system and in the State's central accounting records. Finally, we make recommendations for improved internal controls related to the processing of computerized information.

Your office's responses to our recommendations are included in the text so that readers may see your intended resolution of the matters discussed. In future audits, the Audit Bureau will determine the extent to which the findings in this letter have been resolved.

Our auditors found your staff to be helpful and responsive to their requests. We appreciate the courtesy and cooperation extended to us during the audit.

Sincerely,

Janice Mueller

Janice Mueller
State Auditor

JM/BN/bm

cc: Senator Carol A. Roessler
Senator Robert Cowles
Senator Scott Fitzgerald
Senator Mark Miller
Senator Julie Lassa
Representative Suzanne Jeskewitz
Representative Samantha Kerkman
Representative Dean Kaufert
Representative David Travis
Representative David Cullen

REPORT ON CONTROL AND COMPLIANCE

Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards

We have audited the financial statements of the Wisconsin State Life Insurance Fund as of and for the years ended December 31, 2004, 2003, and 2002, and have issued our report thereon dated December 1, 2005. The State Life Insurance Fund's financial statements are presented using the accounting practices prescribed or permitted by the Commissioner of Insurance of the State of Wisconsin. These accounting practices differ from accounting principles generally accepted in the United States of America. Because of the effects of these variances, we issued an adverse opinion on the fair presentation of the financial statements in conformity with accounting principles generally accepted in the United States. However, we issued an unqualified opinion on the fair presentation of the financial statements in conformity with the accounting practices prescribed or permitted by the Commissioner of Insurance. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the State Life Insurance Fund's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Fund's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. We consider as reportable conditions the internal control weaknesses discussed in more detail in the sections of the attached narrative titled:

- Declining Surplus-to-Assets Ratio
- Audited Surplus-to-Assets Ratio
- Investment Reporting
- Other Reporting Errors
- Reconciliation of the General Ledger to WiSMART

Responses from the management of the State Life Insurance Fund are also included in the attached narrative.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions noted above and described in the attached narrative, we consider the weakness in internal control discussed in the section titled Investment Reporting to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State Life Insurance Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards* and is described in the attached narrative in the section titled Declining Surplus-to-Assets Ratio. The results of our tests disclosed no instances of other matters that are required to be reported under *Government Auditing Standards*.

We further noted certain additional matters that are also reported in the attached narrative.

This independent auditor's report is intended for the information and use of the State Life Insurance Fund's staff, the Office of the Commissioner of Insurance, and the Wisconsin Legislature. This independent auditor's report, upon submission to the Joint Legislative Audit Committee, is a matter of public record and its distribution is not limited. However, because we do not express an opinion on internal control over financial reporting or on compliance, this report is not intended to be used by anyone other than these specified parties.

LEGISLATIVE AUDIT BUREAU

December 1, 2005 by Bryan Naab

Bryan Naab
Audit Director

STATE LIFE INSURANCE FUND

The State Life Insurance Fund, which was created in 1911 to provide low-cost individual life insurance to Wisconsin residents, is administered by the Office of the Commissioner of Insurance (OCI). As part of our audit of the State Life Insurance Fund, we reviewed OCI's internal controls over administration of the Fund and compliance with laws and regulations, and followed up on findings identified in past audits. In this narrative, we describe internal control weaknesses that are considered reportable conditions, including investment and other reporting errors and concerns related to cash reconciliations. Of the reportable conditions, we consider the weakness related to investment reporting a material weakness. We also describe an instance of noncompliance with statutes related to the Fund's surplus-to-assets ratio. Finally, we note additional matters that are not considered reportable conditions, including security and access concerns related to the computer system used to manage the Fund's insurance policies, and the need for the Fund to obtain authorization for the disposal of certain records.

Fund Surplus

The surplus balance of the State Life Insurance Fund represents the difference between the assets of the Fund, primarily investment holdings, and its liabilities, primarily funds reserved to cover insurance benefits. The surplus balance grows when the Fund's earnings, including insurance premiums and investment earnings, are greater than its expenses, including benefit expenses and dividends paid to policyholders. It is important that the Fund have an adequate surplus balance in the event the actuarially determined reserve amounts are not sufficient to pay benefits as they come due.

We have two areas of concern related to the surplus-to-assets ratio. First, based on the unaudited information available, the Fund's staff did not appear to take timely action to address a declining surplus-to-assets ratio. As a result, statutory guidelines for the desired surplus-to-assets ratio were not met. Second, because of errors in the Fund's unaudited financial statements, the audited surplus-to-assets ratio is lower than that calculated by the Fund's staff. As a result, staff will need to assess the corrective actions necessary to meet the Fund's goals related to the surplus-to-assets ratio.

Declining Surplus-to-Assets Ratio

Section 607.15, Wis. Stats., provides that the net profits of the Fund are to be distributed annually to policyholders in the form of dividends. However, the Legislature specified that, to the extent feasible, the ratio of the Fund's surplus to its assets is to be between 7.0 percent and 10.0 percent. Each year, staff calculate the surplus-to-assets ratio, based on the Fund's unaudited financial statements. Before 2002, the Fund's unaudited surplus-to-assets ratio exceeded 7.0 percent. For example, the unaudited surplus-to-assets ratio ranged from 10.66 percent on December 31, 1995 to 8.46 percent on December 31, 2001. However, as shown in Table 1, beginning in 2002, the unaudited surplus-to-assets ratio began to decline below the statutory guidelines, reaching a low of 4.63 percent as of December 31, 2004.

Table 1

Unaudited Surplus-to-Assets Ratio

December 31	Unaudited Surplus-to-Assets Ratio
2001	8.46%
2002	6.60
2003	5.86
2004	4.63

Some factors affecting changes in the surplus-to-assets ratio, such as required reserve balances and investment returns, cannot be controlled by the Fund's staff. However, staff can control the level of dividends paid to policyholders, and it would be expected that, at least annually, staff would determine whether an adjustment to the dividends was needed to allow the Fund to maintain a surplus-to-assets ratio within the statutory guidelines. If a dividend adjustment became necessary, the Fund's staff could be expected to work with its actuary to review assumptions, such as anticipated investment earnings and the mortality rates that are used in the calculation of the dividend scale. The dividend scale specifies the level of dividends to pay to the various types of policyholders.

The dividend scale that was used to pay dividends throughout our audit period went into effect in 1998 and was based on expected investment earnings, expenses, and mortality assumptions at that time. It was projected initially that the lifetime of this scale would be two to three years, but an actuarial report issued in February 2003 concluded that the dividend scale could be supported through March 31, 2003.

We are concerned because when the surplus-to-assets ratio continued to decline in 2003, largely because dividend payments exceeded earnings and reserve balances increased, the Fund's staff did not take any documented steps to assess the need for adjusting the dividend scale. In discussions with us, staff said that they were aware the ratio was below 7.0 percent and that perhaps dividends should have been reviewed more closely, but they also noted that in 2003, the Fund was in the process of changing actuarial firms, and they wanted to wait to adjust the dividend scale until the new actuary was hired in April 2004. However, no action was taken by the Fund's staff in 2004, and it was not until March 2005, in response to the continued decline in the unaudited surplus-to-assets ratio, that the Fund's actuary developed a new dividend scale. The new scale took effect in August 2005.

☑ ***Recommendation***

We recommend the State Life Insurance Fund monitor the surplus-to-assets ratio on an annual basis to determine if the ratio is within the 7.0 to 10.0 percent guideline set forth in Wisconsin Statutes and, if not, document actions taken to address the shortfall.

Agency Response: We agree that the Fund should review the surplus-to-assets ratio on an annual basis and have developed procedures to ensure this happens.

The Regulation and Enforcement Division of OCI had notified the Fund's management as to the relationship between the surplus and assets each year after the Fund filed its annual statement. The Fund was going through the process of contracting for a new actuary and could not review the dividends until the new contract was in place. In addition, the Fund went through an update of the computerized policy administration system, which needed to be tested in February 2003 before staff could approach another change to policy values.

The new actuary started work on the new dividend structure as soon as information was made available for him based on previous years' work.

The surplus-to-assets ratio is monitored, but the timing of the loss of a staff person, a new actuary, the system upgrade, and the Investment Board's liquidation of the private placement bond portfolio was not conducive to making a change before this year. Usually, the Fund has little change from year to year in events that affect the surplus so strongly.

The Regulation and Enforcement Division of OCI will continue to notify the Fund's management of the surplus situation and assist the Commissioner, management, and the contracting actuary in developing any action plan needed in the event the actual ratio is less than the 7.0 to 10.0 percent statutory guideline.

Audited Surplus-to-Assets Ratio

We are also concerned because the actuary's analysis was based on unaudited financial statements that contained significant errors. As a result, the Fund's surplus balance was misstated.

The revised dividend scale effective in August 2005 was expected to allow the surplus balance to increase so that the surplus-to-assets ratio would reach a minimum of 7.0 percent within the next two years. However, those calculations were based on an unaudited surplus-to-assets ratio of 4.63 percent as of December 31, 2004. As shown in Table 2, based on the audited financial statements, the actual surplus-to-assets ratio has been lower than the unaudited ratio for each year during our audit period and, as of December 31, 2004, the audited surplus-to-assets ratio was actually 2.68 percent.

Table 2

Comparison of Unaudited and Audited Surplus-to-Assets Ratios

December 31	Unaudited Ratio[1]	Audited Ratio[2]
2002	6.60%	5.46%
2003	5.86	4.23
2004	4.63	2.68

[1] Calculated using the surplus and assets reported in unaudited financial statements.
[2] Calculated using the surplus and assets reported in audited financial statements.

Because the actual surplus-to-assets ratio is lower than that used in the actuary's calculations, it may take additional time for the revised dividend scale to bring the surplus-to-assets ratio within the desired range.

☑ ***Recommendation***

We recommend staff of the State Life Insurance Fund consider the effects of the audit adjustments and whether the dividend scale implemented in August 2005 will continue to meet the Fund's time frame for achieving the desired surplus-to-assets ratio.

Agency Response: The Fund continues to monitor its surplus-to-assets ratio with its actuary. Effective January 1, 2006, the dividend scale will be readjusted to reflect investment earnings of 6.0 percent, as opposed to the 6.81 percent that was reflected in the dividend scale effective August 1, 2005. This, along with a 1.0 to 2.0 percent reduction in interest paid on balances left to accumulate in the Fund, is projected to bring the surplus-to-assets ratio within the 7.0 to 10.0 percent range by the end of calendar year 2008.

Financial Reporting

The financial statements of the State Life Insurance Fund are to be prepared in accordance with the accounting provisions of the National Association of Insurance Commissioners (NAIC). During our audit, we identified deficiencies in the Fund's accounting and financial reporting procedures, resulting in the need for significant adjustments to the unaudited financial statements. As shown in Table 3, the audit adjustments increased the reported net loss by $1.1 million for

2002, $219,000 for 2003, and $279,000 for 2004. As required by NAIC accounting provisions, policy dividends are considered an expense in the calculation of net income or loss.

Table 3

Effect of Audit Adjustments on Net Income (Loss)

Account/Year	Unaudited Balance	Audited Balance	Difference
Net Income (Loss)			
2002	($1,061,357)	($2,153,803)	($1,092,446)
2003	(641,519)	(860,852)	(219,333)
2004	(852,566)	(1,131,822)	(279,256)

The combined effect of these errors was to reduce the Fund's December 31, 2004 surplus by almost $1.6 million, from $3.8 million as reported in the Fund's unaudited financial statements to $2.2 million as reported in the audited financial statements.

The majority of these errors relate to incomplete understanding of accounting and financial reporting for investments by the Fund's staff. In addition, staff made other accounting errors that we believe could have been detected and investigated through routine review of the Fund's financial statements.

Investment Reporting

In order to prevent significant fluctuations in the recognition of income, NAIC's accounting policies require that realized gains and losses on the sale of investments be smoothed over the remaining life of those investments sold. For example, if a bond that will mature in five years is sold at a gain, the gain is to be recognized over the next five years. NAIC requires the interest maintenance reserve account to be used to accumulate and smooth the recognition of realized gains and losses on the sale of investments that occur because of normal market fluctuations.

However, if realized losses are the result of a decline in the creditworthiness of the investments, NAIC accounting policies require the credit-related losses to be immediately charged against the current year's net income. In addition, in order to lessen the effects of credit-related losses on the Fund's surplus balance, NAIC requires the Fund to also establish reserves in an asset valuation reserve account. Therefore, if a company goes bankrupt and the Fund sells its investment in that company at a loss, the loss would be charged immediately against net income, and the loss would reduce any balances previously set aside in the asset valuation reserve.

In order to determine whether a loss is the result of a decline in the creditworthiness of the investment, NAIC assigns quality ratings to bonds. The Fund's staff are to compare the quality rating at the time of sale to the quality rating at the time of purchase to determine whether any decline in quality rating was large enough to require the loss to be accounted for as a credit-related loss. Further, NAIC has developed procedures to determine the maximum amount to set aside in the asset valuation reserve, which is dependent on the quality ratings of the Fund's investments at the end of each calendar year.

We identified several concerns with the Fund's accounting and financial reporting of investments. First, we noted several instances in which credit-related investment losses were inappropriately accounted for in the interest maintenance reserve. These errors occurred because the Fund's staff did not determine the quality rating of these investments at the time of sale and, therefore, did not determine that these sales met the criteria to be accounted for as credit-related losses. As a result, losses totaling $1,871,973 were recognized over a period of time equivalent to the remaining lives of the investments sold, rather than immediately charged to net income. This occurred for the following sales:

- January 2002 sale of Lucent Technologies fixed-income securities at a loss of $214,290;

- June 2002 sale of WorldCom fixed-income securities at a loss of $823,256;

- July 2002 sale of Xerox fixed-income securities at a loss of $335,342; and

- September 2003 sale of Jet Equipment fixed-income securities at a loss of $499,085.

Second, as the result of an error in accounting for the July 2002 sale of Xerox securities, $279,057 of the $335,342 in investment losses was erroneously reported in calendar year 2003. The remaining $56,285 in losses from the July 2002 sale of Xerox securities was reported in calendar year 2002.

Third, in determining the various amounts related to the asset valuation reserve, staff used inaccurate quality ratings for seven investments held at the end of December 31, 2002, and three investments held as of December 31, 2004. As a result, there was an understatement of $85,971 in the calculation of the required contribution to the reserve for 2002, and an overstatement of $23,044 for 2004.

Finally, in 2002 and prior years, staff used calculations prepared by the Fund's actuary to determine the balances and other amounts related to the interest maintenance reserve and the asset valuation reserve. However, for 2003 and 2004, staff relied upon calculations related to the income maintenance reserve and asset valuation reserve performed by the Fund's bond accounting system without testing the accuracy of these amounts. In comparing 2003 information to 2002 information, it was apparent that the bond system's calculations were in error.

As shown in Table 4, the combined effect of these and other errors was to misstate the balances in the interest maintenance reserve and the asset valuation reserve. The errors accounted for the majority of the $1.6 million in total audit adjustments to the Fund's surplus.

Table 4

Difference between Unaudited and Audited Balances

Account/Year	Unaudited Balance	Audited Balance	Difference
Interest Maintenance Reserve			
2002	$1,044,067	$2,125,431	($1,081,364)
2003	370,001	2,175,494	(1,805,493)
2004	274,318	1,823,800	(1,549,482)
Asset Valuation Reserve			
2002	323,306	0	323,306
2003	137,516	0	137,306
2004	208,662	68,286	140,376

We determined the necessary accounting entries to correctly report both the interest maintenance reserve and the asset valuation reserve, and provided the entries to the Fund's staff, who reviewed and agreed with them. To correct for the errors summarized in Table 4, the December 31, 2004 fund surplus as reported in the audited financial statements was reduced by $1.4 million. It appears that the Fund's staff was not fully aware of how reserve balances were calculated and how the quality ratings on investments at the time of sale affected the way that realized gains and losses were to be accounted for and reported in the financial statements. In addition, the Fund's staff did not have written procedures for determining the quality ratings at the time of sale.

☑ ***Recommendation***

We recommend staff overseeing the State Life Insurance Fund:

- *learn the requirements and prepare written procedures for accounting for investment transactions and calculating and reporting the interest maintenance reserve and the asset valuation reserve;*
- *determine the quality rating of investments at the time of sale and ensure that the realized gain or loss on sales is properly accounted for; and*
- *take more care in ensuring the quality ratings are determined for all investments held by the Fund at the end of the year for purposes of calculating the asset valuation reserve.*

Agency Response: The staff person responsible for the bond system and the Fund Director will prepare written procedures for investment transactions. OCI's Regulation and Enforcement Division will be consulted to ensure the procedures meet regulatory requirements.

Fund staff will assess the quality ratings of bonds sold at the time of sale and will assess the quality ratings of all bonds held in the bond portfolio during end-of-year financial reporting to determine whether there are any issues that would affect the amount of the Asset Valuation Reserve or Interest Maintenance Reserve to be reported in the financial statements.

Other Reporting Errors

In addition to the errors we noted that related to investments, we found two other significant errors we believe the Fund's staff should have identified and investigated during preparation of the annual financial report:

- An error in the report used to determine the balance for advance premiums resulted in a $544,559 overstatement in this liability as of December 31, 2003. This account balance has historically been below $100,000.

- The calculation for the liability for incurred-but-not-reported death benefits as of December 31, 2002, included claims that were actually in the course of being settled and were already considered an outstanding liability. This error resulted in an overstatement of $92,087 in the Fund's liabilities and expenses for 2002.

☑ ***Recommendation***

We recommend the State Life Insurance Fund take more care in the preparation of the annual financial report, review and identify any amounts that are different than would be expected, and analyze whether such amounts are based on accurate and reliable financial information.

Agency Response: The error reported in advance premiums for 2003 was the result of a computer system error, which is in the process of being corrected by the vendor. It is expected that the system error will be corrected by the end of calendar year 2005.

The error in the reporting of the incurred-but-not-reported liability was an oversight in 2002. Notes have been made in the year-end reporting procedures related to this calculation to help ensure similar errors will not occur in the future.

The biggest problem with financial reporting overall was investment reporting and the loss of the position that had that job duty. The State of Wisconsin Investment Board sold off the private placement holdings in 2002, which added to the losses incurred in 2002. Fund staff will work with the State of Wisconsin Investment Board to make sure bond sales are better coordinated. Any adjustments to the existing investment guidelines that may be necessary will be implemented.

The Regulation and Enforcement Division of OCI will provide staff involvement and expertise to assist the Fund as needed in preparing future financial statements.

Reconciliation of the General Ledger to WiSMART

State Life Insurance Fund staff use several different agency-level accounting systems to record the Fund's financial transactions and to provide the information needed to prepare the Fund's annual financial statements. One of these systems, the general ledger system, records all activity for the Fund. In addition, staff use WiSMART, the State's central accounting system, to process the payment of checks, such as for dividends and payment claims, as well as other receipts and disbursements of the Fund.

WiSMART is also used by other state agencies responsible for recording financial transactions of the Fund. For example, the State Controller's Office records premium revenue the Fund receives through a lockbox and the State of Wisconsin Investment Board records sales and purchases of investments and investment revenue. Financial transactions recorded on WiSMART by these other agencies are entered by the Fund's staff into the general ledger system, as well as its other systems as needed. It is important to reconcile the WiSMART records to the Fund's general ledger and other systems to ensure all transactions processed by WiSMART are properly reflected in the Fund's accounting systems.

In past audits, we noted concerns related to the lack of adequate reconciliations between the general ledger system and WiSMART. In response to our prior audit recommendation, the Fund's staff stated they would reconcile the general ledger to WiSMART as of June 30, 2003. However, staff have not taken the necessary steps to perform this reconciliation, indicating that performing reconciliations was given low priority because of the loss of a staff position. In addition, staff note that it is difficult to reconcile the general ledger to WiSMART because the two systems use different accounts and different reporting periods.

However, we continue to be concerned because, since at least 1994, the Fund's general ledger cash balance has differed from the WiSMART cash balance and, as of December 31, 2004, the variance between the two systems had reached $190,240, with the cash balance in WiSMART lower than the cash balance recorded in the Fund's general ledger. Because the Fund's staff have not reconciled the systems, the risk is increased that unauthorized or inappropriate cash transactions could be processed on WiSMART and remain undetected. In addition, because staff use the general ledger to prepare the Fund's financial statements, the reported cash balance could cause it to be misstated.

During our current audit, we performed additional procedures to analyze calendar year 2004 cash transactions. We identified several transactions recorded on WiSMART that should have been, but were not, recorded on the general ledger. For example:

- $1,200 required lapse from the Fund for a fifth week of vacation was recorded on WiSMART by the Department of Administration but not on the general ledger by the Fund's staff; and

- $6,075 payment from the Fund for investment-related transactions was recorded on WiSMART by the State of Wisconsin Investment Board but not on the general ledger by the Fund's staff.

These transactions appear to be appropriate and related to the Fund's activity. We also reviewed selected transactions for calendar years 2002 and 2003 and found that similarly appropriate transactions were recorded on WiSMART but not on the general ledger.

To properly report financial activity in the Fund's financial statements, we proposed and staff accepted various adjustments to the draft statements. The net effect of these adjustments is to reduce the Fund's December 31, 2004 cash and fund surplus by $190,240.

To ensure that unadjusted variances do not continue, the Fund's staff should reconcile the cash balance on the general ledger and WiSMART on an ongoing basis and ensure that cash is properly accounted for and safeguarded. We discussed the need for reconciliations with staff and suggested procedures to facilitate monthly reconciliations. Staff indicated their intent to perform monthly reconciliations, beginning with January 2005.

☑ ***Recommendation***

We recommend the State Life Insurance Fund perform monthly reconciliations of the cash balances reported in its general ledger and in WiSMART, to ensure all transactions are properly recorded.

Agency Response: We have made the necessary accounting entries to bring the cash account on the Fund's general ledger into agreement with the ending cash balance recorded on WiSMART for December 31, 2004.

We agree as to the importance of reconciliations of the various systems used within the Fund. The cash reconciliation has been successfully done for January 2005 and we are working to complete reconciliations for subsequent months. On a going-forward basis, the Fund accountant will complete reconciliations on a monthly basis before running the general ledger for that time period. With the assistance of the Department of Administration personnel and an outside vendor, we are working on a system to integrate all WiSMART transactions directly into a new ledger system.

Security over Computer Systems

Controlling access to computer systems is important to ensure that computer programs and data are protected from improper access and use. If access is not limited to appropriate staff, computer programs and data may be intentionally or unintentionally damaged or manipulated. We continue to note concerns over security and access to the Flexible Insurance, Marketing, Management, and Administration System (FIMMAS), which increases the risk of unauthorized access to the system.

Vendor Access

FIMMAS is used to account for and manage all of the Fund's insurance policies, including generating premium notices, tracking accumulated dividends, and determining the cash surrender value of the policies. Since FIMMAS was implemented in 1993, we have expressed concern regarding the access granted to the vendor that developed and continues to maintain the system. The Fund's staff have taken only limited steps to address our concerns. We continue to be concerned because OCI allows the vendor access to the FIMMAS production environment and because OCI does not actively monitor the vendor's access to the FIMMAS test environment. Because of the knowledge the vendor has of FIMMAS, the vendor could make unauthorized changes to the computer programs or data, which could allow unauthorized transactions to be processed and concealed. For example, a programmer could change the name and address of check payees and then take additional steps to conceal these changes.

In response to our prior audit concerns related to access to the production environment, OCI staff indicated that they would evaluate the costs versus the benefits of a second computer server that would contain the FIMMAS test system and would limit the vendor's access to only the test environment. This would allow OCI to eliminate the vendor's access to the production environment. However, OCI did not complete this analysis and continues to allow the vendor access to the production environment.

In response to our prior audit recommendation related to the test environment, OCI indicated that it recognized the need to monitor access to FIMMAS and that it would generate and review reports listing successful and failed attempts to access the computer server on which FIMMAS resides. Successful attempts would be further reviewed with the Fund's manager to ensure the access was the result of a request for the vendor to perform work on FIMMAS. However, during our current audit period, we found that OCI has not generated any security reports indicating failed and successful attempts by the vendor to access the computer server. As a result, OCI has not assured itself that vendor access to the system was limited to legitimate purposes. Therefore, it is possible that the vendor made unauthorized changes to the computer program.

☑ ***Recommendation***

We recommend the Office of the Commissioner of Insurance:

- *remove the vendor's access to the production environment; and*
- *establish procedures to routinely generate and review security reports for FIMMAS, including procedures that monitor failed access attempts and assess the appropriateness of successful access attempts*.

Agency Response: There are situations that require immediate intervention regarding a system fix or a field that is not appearing because of a report's length. For example, these fixes have occurred on December 31st, when OCI information technology staff are not available and reports and files need to be run and updated. Under the current arrangements, the vendor then has the ability to access our system and make the necessary changes. This eliminates the need for intervention from OCI information technology staff and provides the Fund's staff with immediate results.

The Fund is pursuing the option to have the FIMMAS vendor maintain our database on its servers. The vendor has management reports that provide information as to who has performed what tasks and when they were performed. Fund staff will develop a log to track system modifications and corrections that are requested. The log will be compared against the vendor management reports and discrepancies reconciled no less than on a quarterly basis.

Additionally, the vendor's staff are trained in the current privacy laws. We have put in place the oversight to ensure that we are in compliance, and we sign the necessary nondisclosure agreements to comply with privacy directives. If, after making these steps, OCI determines controls are not adequate, we will consider removing the production access from the vendor and having our information technology staff handle the physical moves of application code from the test server to the production server, even though the server is physically housed at the vendor's location.

Password Protections

FIMMAS users need to have valid user identifications (IDs) and passwords to access OCI's local area network. Once a user has logged on to the network, the FIMMAS system verifies that the user ID and password is valid for the FIMMAS system before granting access.

To ensure security is maintained over the FIMMAS system, it is important that OCI establish acceptable password standards that reduce the risk that unauthorized users are able to guess passwords and obtain access to the system, including access to data and transactions. Further, if an unauthorized user gains access, it is difficult to detect and determine the unauthorized person's identity.

OCI's local area network has several password security features that could be used to reduce the risk of unauthorized access to FIMMAS. However, in reviewing the network password restrictions specific to the Fund's staff, we found that the only password restriction used is that the password must be at least five characters in length. Other standard password security features that were not in place include:

- requiring passwords to be changed at specified intervals. Industry standards suggest that individuals with access to critical data or powerful privileges, such as administration privileges, be required to change their passwords at least every 30 days, and all other users at least every 60 days;

- requiring new and unique passwords for a specified number of password changes, to prevent users from continually using the same passwords; and

- requiring a longer password length. Industry standards suggest that five characters long is a minimum but that longer passwords are preferable.

In discussions with us, OCI staff noted that more stringent password standards are planned, such as increasing the minimum password length to 7 characters. However, these new standards have yet to be put into place.

☑ ***Recommendation***

We recommend the Office of the Commissioner of Insurance take advantage of available password security features to reduce the risk that unauthorized users are able to guess passwords and gain access to FIMMAS and related data.

Agency Response: The current design of the client server application does not provide a mechanism for processing operating system password changes. OCI will work with Management Data, Inc., the vendor for FIMMAS, to explore solutions for implementing password changes.

Record Disposal Authorization

Controls over the retention and disposal of state records are vital for ensuring that hard copies and computer files are available for disaster recovery, historical documentation, and audit support. The Public Records and Forms Board has the responsibility for establishing procedures for the disposition of state records. Section 16.61, Wis. Stats., requires that state agencies submit record retention schedules to the Public Records and Forms Board within one year of the creation or reception of record series, including electronically stored records.

In our prior audit, we found that the only records of the Fund for which a disposal authorization existed were life insurance termination files. Since our last audit, OCI submitted a record disposal authorization for the FIMMAS system. However, OCI still does not have record disposal authorization for the records related to the Fund's bond system. OCI staff note that they have retained all bond system records and that none of the records have been destroyed.

☑ ***Recommendation***

We recommend the Office of the Commissioner of Insurance develop and submit a record disposal authorization for the State Life Insurance Fund's bond system.

Agency Response: The staff person responsible for the bond system and OCI's Records Coordinator are working on a records disposal authorization for the bond system, which will be completed by March 31, 2006.

The person who handled the bond system left in July 2003, and the current staff person was not knowledgeable at the time to draft a request for records destruction authorization on the system.

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