EXAMINATION OF CERTAIN POLICIES, PROCEDURES, CONTROLS, AND FINANCIAL ACTIVITIES OF THE KENTUCKY EMPLOYERS' MUTUAL INSURANCE COMPANY

MIKE HARMON
AUDITOR OF PUBLIC ACCOUNTS

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April 16, 2019

Jon E. Stewart, Manager
Kentucky Employers' Mutual Insurance Company
250 W. Main Street, STE 900
Lexington, KY 40507

Dear Mr. Stewart:

The Auditor of Public Accounts (APA) has completed its examination of the Kentucky Employers' Mutual Insurance Company (KEMI). This report summarizes the procedures performed and communicates the results of those procedures.

The purpose of this examination was not to provide an opinion on the financial statements, but to ensure appropriate processes are in place to provide strong fiscal management and oversight of the activity of KEMI and to review specific issues brought to the attention of this office.

Detailed findings and recommendations based on our examination are presented in this report to assist KEMI in implementing corrective action. Overall, these findings indicate the following:

- I recommend a greater role for policyholder governance at KEMI.

- The Board of Directors and management should openly discuss and clarify their expectations for the governance structure and level of oversight of KEMI operations.

- KEMI procurement policies should be further revised to increase accountability and competitiveness.

- There are significant concerns regarding the hiring of a broker by KEMI management that point to the need for greater Board oversight of contracts and adherence to procurement policies.

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We appreciate your assistance and the assistance of your staff throughout the examination. If you have any questions or wish to discuss this report further, please contact me or L. Christopher Hunt, Executive Director, Auditor of Public Accounts.

Sincerely,

Mike Harmon
Auditor of Public Accounts

CHAPTER I: THE ROLE & NATURE OF KEMI

An examination of the Kentucky Employers' Mutual Insurance Company (KEMI) requires an understanding of its organization and role as a state-created entity that operates in the competitive market. This context informs and sometimes confounds KEMI governance, policy, and operations—depending on the various interpretations of the nature of KEMI. Based on the following discussion, this examination by the Auditor of Public Accounts (APA) used criteria applicable to state agencies as a point of reference. However, it should be noted that KEMI operates competitively with private entities. The statutes creating KEMI couch its public role in language referring to its independence and competitive nature.

Formation of KEMI

KEMI, located in downtown Lexington, is the largest provider of workers' compensation insurance in Kentucky, providing coverage to more than 23,000 policyholders in all 120 counties of the state. KEMI was created by the General Assembly in 1994 through Kentucky Revised Statute (KRS) 342.803, which states, in part:

KEMI provides coverage to over 23,000 policyholders throughout Kentucky.

> The Kentucky Employers' Mutual Insurance Authority is created as a nonprofit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth which shall be a public body corporate and politic to insure employers in the Commonwealth for workers' compensation, employers' liability insurance and coverage required by the Federal Coal Mine Health & Safety Act, the Jones Act, and the Longshore and Harbor Workers Act incidental to and written in conjunction with workers' compensation…The authority shall function in a manner similar to a governing board for a domestic mutual insurance company and shall be subject to the provisions of KRS Chapter 304 applicable to domestic mutual insurance companies, unless otherwise provided or exempted in KRS 342.801 to 302.843.

Additional statutes reflect the dual nature of KEMI as a participant in the voluntary, competitive insurance market, as well as insurer of last resort:

- "An adequate and available workers' compensation insurance market does not exist for employers in the Commonwealth." KRS 342.801(1)(a).
- "The authority shall provide coverage to any employer who is unable to secure coverage in the voluntary market unless the employer owes undisputed premiums to a previous workers' compensation carrier or to a workers' compensation residual market mechanism." KRS 342.815(2).
- "The authority shall provide coverage and issue policies as an insurer in the voluntary market and as an insurer of last resort." KRS 342.803(4).
- "[I]t is the intent of the General Assembly in creating the Employers' Mutual Insurance Authority to establish a self-supporting competitive state fund for the purpose of

providing both a market of last resort for employers in the Commonwealth and another competitive source of insurance in the voluntary market through which employers may secure and maintain their workers' compensation coverage required under this chapter." KRS 342.801(2).

The discussion in Appendix A: Loss Portfolio Transfer Agreements emphasizes KEMI's unique relationship with the Commonwealth as the insurer of last resort. The two funds related to the agreements were not included in this examination because no additional administrative or overhead charges were charged by KEMI to administer them.

Initially, KEMI was funded and organized using state funds, but has since repaid the $7 million start-up loan provided by the Kentucky Workers' Compensation Funding Commission and operates as a self-supporting entity. Although KEMI does not currently receive state appropriations, the entity must operate in both the public and private sectors. KEMI is required to present personal service contracts (PSCs) to the Government Contract Review Committee (GCRC) for approval and quarterly reports of assets and liabilities to the Board, the Governor, and the Legislative Research Commission (LRC). The Board membership is comprised entirely of gubernatorial appointees and Cabinet Secretaries (also selected by the Governor). KEMI is self-supporting and its liabilities are not a debt of the Commonwealth. KEMI provides coverage and issues policies as an insurer in the voluntary market and as an insurer of last resort. Its vision is to "lead the workers' compensation industry and be the carrier of choice for Kentucky businesses" by protecting policyholders, promoting safer workplaces, and assisting injured workers while preserving their financial stability. The operating budget for year 2018 was $32,887,545 and KEMI employed nearly 214 individuals in that same year.

Financial Overview

KEMI is owned by its policyholders and financed by premium dollars earned from policyholders and investment income. Per KRS 342.829, KEMI "shall not receive any direct state general fund appropriation." Therefore, KEMI operates from use of policyholder funds rather than public funds. In its most recent audited financial statements, KEMI reported 2017 net income of $10,719,927, the product of a net underwriting loss of $13,261,882, net investment income of $22,813,377, net realized capital gains of $5,304,734, pension and postretirement benefits expenses of $3,762,569, and bad debt and other expenses of $373,733. As of February 28, 2019, $24,741,942 of the $152,489,466 in premiums paid by policyholders were paid by public entities.

Approximately 16% of KEMI Premiums are Paid by Public Entities.

KEMI separated into 17 categories their 2018 general expense budget for operating expenses unrelated to claims and capital expenditures. The category of Salaries & Payroll Taxes is the highest anticipated expense at $18,520,536, equal to 56.3% of the entire 2018 general expense budget. Employee Benefits are the second highest expense at $5,625,124, equal to 17.1% of the 2018 budget. Figure 1 below provides the budgets for each of the 17 categories.

Figure 1: KEMI's 2018 Budgeted General Expenses

General Expenses Categories	2018 Budget
Salaries & Payroll Taxes	$18,520,536
Outsource Staffing	-
Employee Benefits	5,625,124
Outside Services	532,114
Surveys & Underwriting Reports	826,897
Rent & Building Maintenance	1,467,888
Postage, Telephone & Internet	372,058
Office Supplies, Printing & Publications	272,433
Advertising	501,914
Audits of Assureds' Records	45,000
Travel	394,703
Equipment & Software	1,527,704
Legal, Actuarial & Auditing	351,000
Licenses & Fees	146,520
Investment Expenses & Bank Charges	1,862,200
Business Insurance	250,000
General Expenses Categories	**2018 Budget**
Boards, Bureaus & Associations	171,455
Total General Expenses:	**$32,867,544**

Source: APA, based on KEMI's 2018 budget

Additional discussion of employee compensation is available at Appendix B: Employee Salaries, Benefits, and Other Perquisites.

Dividends

KEMI was created as a nonprofit public entity designed to function as a domestic mutual insurance company to provide workers' compensation coverage as a market of last resort and as an insurer in the voluntary market. Per KRS 342.819, the Board has discretion to declare dividends, premium discounts, or a combination of both, if there are adequate funds available. KEMI's Manager has established an annual process by which to determine if a dividend may be given to policy holders. The calculation for a respective dividend payment is lengthy because, per KEMI's process, they wait three years in order to determine their final losses related to claims for a policy year. While budgetary spending impacts KEMI's bottom line, it appears that Net Incurred Losses related to claims have the biggest impact on KEMI's Net Income. The more significant their loss, the less likely they would be able to issue a dividend payment. To date, KEMI has issued a total of four dividend disbursements. The first dividend payment totaled $30.8 million and was issued on March 25, 2010 for the 1995 through 2008 policy years. The second dividend payment on August 14, 2012, totaled $4.7 million and was issued for the 2009 policy year. The third dividend payment of $6.4 million issued on August 13, 2013 was made payable to policyholders for the 2010 policy year. The final dividend disbursement to date of $3.4 million was issued on August 26, 2014 for the 2011 policy year. KEMI has issued $45.3 million in dividends to date.

Impetus of Examination

On April 3, 2018, the Auditor of Public Accounts (APA) initiated a special examination of Kentucky Employers' Mutual Insurance Company (KEMI). The special examination was requested by letter from the Chairperson of the Board of Directors (Board).

Scope of Examination

The purpose of this examination was not to provide an opinion on the financial statements or to duplicate work of KEMI's annual financial statement audits. The objectives of this examination were to determine whether policies and internal controls governing the financial activity of KEMI are adequate, provide the appropriate level of approval, are consistently followed, and provide for a transparent process. The examination also evaluated whether the governance and oversight structure of the Board is sufficient to ensure accountability and transparency of spending and operations. The scope of this examination included examining records, activities, and other information for the period January 1, 2016 through April 30, 2018, unless otherwise specified; however, the time period of certain documents reviewed and issues discussed with those interviewed may have varied. Additionally, due to significant events impacting KEMI since April 30, 2018, the examination was expanded as needed to keep the examination current and to understand the impact of those events on its governance.

To address the objectives of the examination, the APA has interviewed past and present members of the Board, the President/Manager/CEO (Manager), and other KEMI personnel. The APA has also reviewed and analyzed thousands of documents, including emails, reports, supporting documentation and schedules, and policies.

Approach and Key Results of Examination

The following factors suggest that KEMI should tighten its operations and compliance to be more transparent and accountable consistent with rules applicable to state agencies, even in the context of operating in a competitive private market:

- KEMI was created by legislative action as a "political subdivision" and "municipal corporation" of the Commonwealth, albeit an "independent" and "self-supporting" one.
- KEMI deals with policyholder funds, a portion of which are derived from policies held by public entities, using public funds.
- KEMI is subject to open record laws, executive branch ethics, procurement rules (see Finding 3, page 21), and other safeguards typically applicable to Kentucky government entities.

In addition to tightening operations in areas of weak control noted, auditors recommend that KEMI provide rigorous justification and planning for expenses not typically allowable in the government setting such as advertising (see Finding 10, page 52); and business development, employee incentives and perquisites, and non-travel meal expenses, and conferences (see Finding 8, page 43).

This report identifies several governance issues in Chapter II (see page 10). To address these issues, auditors recommend that KEMI be required to have policyholder representation, along with continued representation from the executive branch of state government, on its Board. This would more closely align incentives to oversee spending and operations to provide the best value to policyholders entitled to any dividend or reduction in premiums due to increased efficiency and effectiveness. Discussion of this incentive is found in Finding 1 (page 10).

Report continues with Chapter II on next page.

CHAPTER II: GOVERNANCE REQUIRES CONTINUED ASSESSMENT

Finding 1: The Role and Authority of the KEMI Board and Its Committees Are Not Clearly Established

The role and authority of each committee of the Board is not clearly established. There was no written definition of the role or purpose of each committee during the exam period. In addition, little guidance has been formally given to committees regarding the level of authority they each have. Not clearly establishing the role and authority of each committee of the Board increases the risk of misinterpretation of the governance structure and confusion for future board members.

Board Overview

KEMI is governed by a Board of Directors whose composition is prescribed by Kentucky state law. KRS 342.807 states, in part:

> The authority shall be governed by a board of directors. The board shall exercise complete jurisdiction over the authority. . . In making the appointments to the board, subject to Senate confirmation, the Governor shall ensure adequate representation from the major sectors of the economy and workforce in the Commonwealth.

Members of the board consist of the Secretary of the Finance and Administration Cabinet, Secretary of the Personnel Cabinet, Secretary of the Labor Cabinet, and seven at-large members appointed by the Governor, subject to confirmation by the Senate. The board operates as the governing body of KEMI, and their powers and duties are prescribed by Kentucky state law. KRS 342.811 states, in part:

> The board of directors of the authority shall function in a manner similar to the governing body of a mutual insurance company established pursuant to KRS Chapter 304, with all of the general corporate powers incidental thereto.

The powers and duties entrusted to the board include, but are not limited to:

- Hire a manager to administer the authority in accordance with the policies and procedures of the board.
- Hire an internal auditor who serves at the pleasure of and reports directly to the board on the internal operations of the authority.
- Examine and adopt an annual operating budget for the authority.
- Adopt a procurement policy consistent with the provisions of KRS Chapter 45A, including competitive bidding procedures.
- Approve a personnel policy subject to the provisions of KRS 342.813.
- Approve all contracts entered into by the authority, in accordance with the bylaws and procurement policy of the board.

Committees

The Board Chairperson is responsible for appointing the standing committees and committee chairpersons. The Board Chairperson's authority is prescribed further in Article VII, Section 7 of KEMI's Bylaws, which states:

> The Board Chairperson may also appoint other committees as circumstances require. The Board Chairperson may remove members from and fill vacancies on any committee. The Board Chairperson may be an ex officio member of all committees of the Board.

While KEMI's Bylaws do not name specific committees or functions to be addressed by committees, there are currently six committees that carry out the duties of the Board: Human Resources Committee, Audit/Finance/Investment Committee, Nominating Committee, Executive Committee, Bylaws/Legislative Relations Committee, and the Space Planning Committee.

Only three of the six committees met during the exam period (Nominating Committee, Audit/Finance/Investment Committee, and Human Resources Committee). Although the Board Chairman appointed Committee Members to the Bylaws/Legislative Relations Committee in each year of the exam period, this committee did not meet. The remaining two committees (Space Planning Committee and Executive Committee) were established during the exam period; however, neither of the new committees met during the exam period. A brief description of each Committee, as provided by KEMI on July 30, 2018, follows:

- The **Executive Committee –** Committee was created by action of the Board at the 3/13/2018 board meeting. Appointments were made by Chair. Function not fully defined as yet; however, minutes indicate the committee could look at issues such as procurement. The Committee has not met to-date.

- The **Audit/Finance/Investment Committee -** Past functions of the committee have included review of independent financial audits; structuring, direction, recommendations related to investment management and investment policy; and reviewing budget recommendations. The internal auditor reports to the entire board; however, the committee is currently discussing internal audit scope and may request regular reports from him at future meetings.

- The **Human Resources Committee -** Past functions of the committee have included CEO's (Manager's) performance evaluation process; HR policies; development of salary structure and incentive program.

- The **Bylaws/Legislative Relations Committee** – Past functions of the committee included considering/recommending updates to the board's bylaws. Updates regarding legislative activity have most recently been addressed to the entire Board during board meetings.

- The **Space Planning Committee** – Recently created by Board action at 2/26 meeting which indicated "for the purpose of conducting an RFI or RFP to determine space needs and direction and also to provide a long-term assessment and recommendation regarding the property that KEMI currently owns." The Committee has not met to-date.

- The **Nominating Committee** – The Chair may choose to appoint a Nominating Committee to provide a slate of recommended officers for Board consideration in order to comply with Article VII, Section 1 of the KEMI Bylaws.

Lack of Guidance for Committees

Documentation created by KEMI or the Board that defines the role or purpose of each committee did not exist during the exam period. The Bylaws of KEMI include a section explaining the appointment of committee members; however, the Bylaws do not describe the role or authority of each committee of the Board nor are specific committees mentioned. In a July 17, 2018 inquiry, KEMI management informed auditors that a document defining the role and authority of each committee did not exist. KEMI management then worked with the Board Chair to provide the APA with descriptions of the six committees. These descriptions offer little information beyond dates created for newer committees and previous functions for older ones.

KEMI did not have a document defining the role and authority of each committee of the Board of Directors

While it cannot be confirmed, perhaps this lack of guidance related to purpose is what led to the limited number of committee meetings during the exam period. Three committees of the Board met during the exam period including the Nominating Committee, Audit Finance Investment Committee, and Human Resources Committee. Although the Board Chairperson appointed Committee Members to the Bylaws/Legislative Relations Committee in each year of the exam period, the Committee did not meet. Additionally, during the Board Meeting on February 26, 2018, the Space Planning Committee was established and at the Board Meeting on March 13, 2018, the Executive Committee was established. Neither of the new Committees established in 2018 met during the exam period ending April 30, 2018.

The authority of the committees has also not been formally documented. The Bylaws of KEMI state, "Robert's Rules of Order, latest edition, shall be recognized as the authority governing all meetings of the Board when not in conflict with these Bylaws." However, Robert's Rules of Order do not provide guidance as to levels of authority that committees have, and as noted above, the Bylaws of KEMI do not document each committee's level of authority, but only address membership appointment to committees by the Board Chairperson. Neither KEMI nor the Board have initiated steps to formally document when committees may take action on behalf of the full Board or when ratification of a committee's vote must occur at the Board level. This lack of guidance led to at least once instance in which KEMI took action with only a committee's approval.

Board Chairperson

The Board Chairperson has authority to conduct the Board meetings and other duties as described in the Bylaws of KEMI. Article VII, Section 4 of KEMI's Bylaws state:

> The Chairperson of the Board shall preside at all meetings of the Board. The Chairperson shall have general oversight and supervision over the business, administration, and affairs of the Board. The Chairperson may sign bills, notes, checks, contracts or other instruments which the Board has authorized to be executed. The Chairperson shall also possess and perform such other duties as may be prescribed from time to time by a majority of the Board. The Chairperson, with the Secretary, shall sign the minutes of all Board meetings over which he or she may have presided.

The Chairperson has no individual authority to take any action except as authorized by a majority vote during a Board meeting, when a quorum is present.

This report identifies instances in which the KEMI Manager discussed specific matters with the former Board Chairperson instead of bringing the issues to the full Board during Board meetings. As detailed in Finding 4 (page 28), the KEMI Manager stated he discussed the matter of the Mangold Broker Agreement with the former Board Chairperson, but he did not seek approval from the full Board as the total payment to the Broker was less than $50,000 and did not require Board approval per KEMI policy. Additionally as explained in Finding 2 (page 16), an unbudgeted marketing expenditure exceeding $50,000 was not presented to the Board for approval. While the Manager indicated he and the former Board Chairperson discussed the change in advertising strategy and believes it was discussed at a Board meeting, no such discussions appear to be documented in Board minutes. Notification of the Board Chairperson is not a recognized approval process.

Governance Issue

In 2016, the Audit Finance Investment Committee voted to authorize the Manager to enter into a real estate purchase agreement on behalf of KEMI without taking a vote from the full Board, instead simply informing the full Board of the action taken by the Committee. Language added to the 2014 revised Investment Policy Statement, which was approved by the Audit Finance Investment Committee and the full Board, authorized KEMI to invest in real estate for occupation; however, the Board meeting minutes do not clearly reflect what changes to the policy the Board approved and if that included delegating authority to this committee regarding investments. The real estate purchase is discussed in Finding 4 (page 28).

The 2014 revised Investment Policy states: "The Audit, Finance & Investment Committee ("Committee") of the Board of Directors ("Board") shall serve as investment trustees and fiduciaries of KEMI. The Committee will be responsible on a continuing basis for the establishment, review and implementation of this document. The Committee may delegate to officers, employees or agents the authority to act regarding the investment of the assets of the company…KEMI may choose to purchase real estate for its own use. Such purchase(s) are to be reviewed and approved by KEMI's Investment Committee [.]"

The minutes do not reflect the specific language approved by the Board. Although there may have been authority for the Audit Finance Investment Committee to act, such delegation of authority is not wise as the action taken by the Committee is a binding agreement with a significant impact on KEMI's operations. As such, authorization for such a purpose should require a vote from all members of the Board.

Setting the roles and authority of each committee in the Bylaws might avoid this type of ad hoc delegation in the future. In almost all instances, the role of committees should be bringing recommendations to the full Board because the Board has been given the authority to direct KEMI. Any delegation of that authority puts the Board at risk of not realizing what is happening and not having control.

Alignment of Interests

Out of ten board members, only one is also a KEMI policy holder. This member is only a policy holder indirectly through the law firm of which he is a partner. He plays no role in this firm's workers' compensation insurance process. In a mutual insurance company, the owners are the policy holders. KEMI does not handle public funds directly, but does handle funds from the policy holders and should be accountable to them.

Only one current board member participates in a business that is a KEMI policyholder.

A misalignment of purpose occurs when those charged with governance (the Board) have different incentives from those to whom benefits accrue (the policy holders). When Board members are neither policy holders nor directly responsible to policy holders, there is no incentive for Board members to keep costs low and hold management accountable for revenue targets. When a mutual insurance company is profitable, the economic benefit is passed along to policy holders in the form of dividends or in reduced premiums. Board members are currently accountable to the Governor (for ex-officio members, although their specific oversight of KEMI is not a large part of their responsibility to the Governor) or to the Governor and the Kentucky Senate (for members appointed specifically by the Governor and confirmed by the Senate). The incentives for current Board members therefore are largely political and not directly tied to satisfaction of policy holders. Board members do not participate in a direct benefit to an increase of dividends or a reduction in premiums paid by policy holders.

The American Association of State Compensation Insurance Funds (AASCIF), an association of 26 state workers' compensation insurance companies and eight Canadian workers' compensation boards, classifies KEMI as a competitive entity along with California, Colorado, Hawaii, Idaho, Louisiana, Maine, Maryland, Minnesota, Missouri, Montana, New Mexico, Oklahoma, Oregon, Rhode Island, Texas, and Utah.

Of these competitive states:

- Texas's board has four out of nine members elected by policy holders.
- Hawaii's board is composed entirely of policy holders.
- Missouri's board is elected by policy holders, but the Governor must approve three of the five board members.
- Maine's board contains seven policy holders and two members appointed by the Governor and reviewed by a committee of the legislature. Six of the seven policy holder members are selected by a nominating committee created by the board. The seventh is elected by the board as President and CEO.
- Rhode Island's board includes three members elected by the policy holders, five appointed by the Governor, and the CEO serves ex-officio.
- Oklahoma's and Utah's have been privatized.

Out of 17 competitive state workers' compensation insurance companies, at least 7 have some provision for policy holder representation on the board. Mutual insurers in Kentucky are defined as those with a governing body elected by policyholders, "or those policyholders specified in its charter, or by any other reasonable method."

Even Number of Board Members

An even number of board members leads to the possibility of stalemates on critical issues due to tied votes (five to five). An odd number of board members decreases the likelihood that the Board would be unable to act on an issue since it could not be evenly divided if all members are present and voting. While no instance of a stalemate has been identified, this is a simple preventative measure.

Recommendations

We recommend the KEMI Board amend the Bylaws to clearly establish the role and authority of each Committee of the Board. If additional Committees are created by the Board, the role of both standing and ad hoc committees should be defined and maintained in writing in an organized place. The Board should carefully reconsider delegating full authority to approve significant transactions to any committee without full board approval.

We recommend that the General Assembly change the requirements for Board membership to require four of the members to be elected by the policy holders and to increase the membership by one. This will allow the Commonwealth to protect its interest in KEMI as an insurer of last resort through the three ex-officio members and the four members appointed by the Governor and confirmed by the Senate, while allowing policy holders a greater oversight ability. The appointed members who are not ex-officio should also be policy holders if possible.

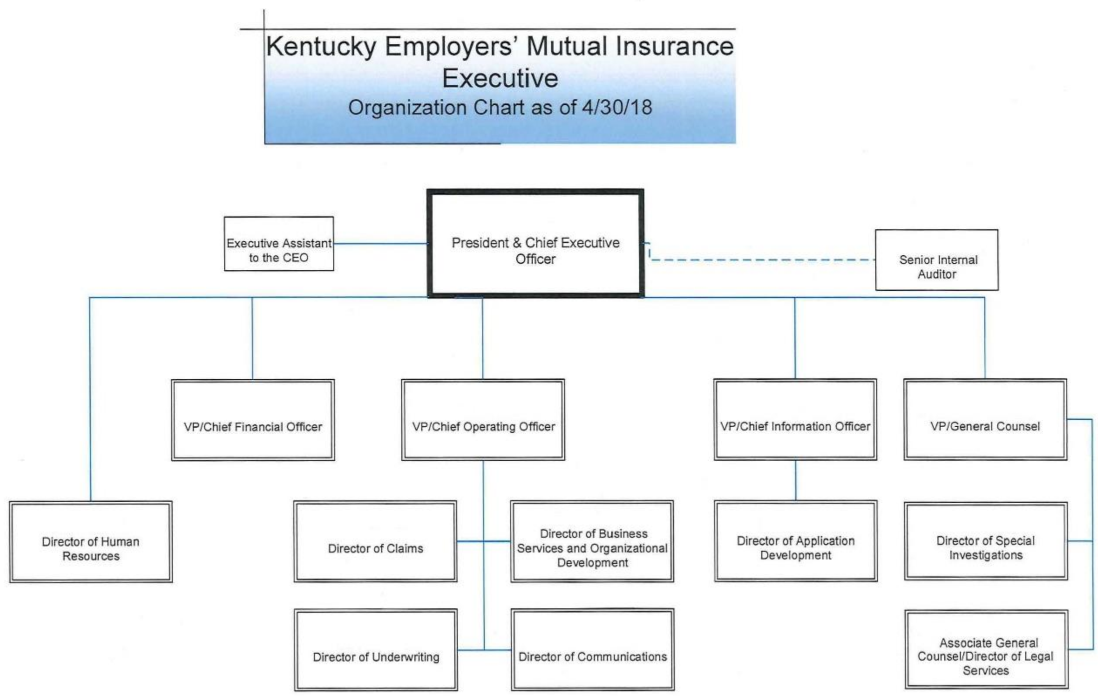
Finding 2: There Are Inconsistencies in the Role and Authority of the Board and Manager

Despite statutory guidance, auditors observed several misunderstandings about the role and authority of the Board versus the Manager during the course of this examination. The contrast in length of service between the two groups, coupled with differing approaches to governance by each board, contributed to conflicting expectations concerning how the Board and Manager should interact. Moving forward, communication between the Board and the Manager is key in fine-tuning individual expectations into agreed-upon actions.

Management Structure

As of April 30, 2018, KEMI's executive staff consisted of the Manager, Senior Internal Auditor, the Manager's assistant, four Vice President (VP) Officers, and eight Directors, as depicted in the following organization chart in Figure 2 (below).

Figure 2: Organization Chart for KEMI as of April 30, 2018



Source: Organization chart as of April 30, 2018 provided by KEMI.

As shown in Figure 2 (above), KEMI consisted of numerous departments and positions reporting either to a VP or directly to the Manager or Board. A brief description of each major department follows, along with an employee count as of the end of the exam period:

- The **VP/Chief Operating Officer (VP/COO)** oversaw the functions of Business Services and Organizational Development, Claims, Communications, and Underwriting, as well as the positions of Reinsurance and Data Analyst and Executive Assistant to the VP/COO.

  - The Business Services and Organizational Development Department employed 31 individuals, including the Director, and consisted of three divisions: Premium Audit, Center for Assistance, and Loss Education & Safety.

  - The Claims Department employed 58 individuals, including the Director, Claims Trainer, and Reinsurance and Data Analyst. The Department was split into two divisions: Claims Billing/Processing and Claims.

  - The Communications Department employed two individuals - a Director and one staff member.

  - The Underwriting Department employed 36 individuals, including the Director, and consisted of two divisions: Underwriting and Business Development & Specialty Program Management.

- The **VP/Chief Financial Officer (VP/CFO)** oversaw the Finance Department, which consisted of the Finance Manager and six staff members.

- The **VP/Chief Information Officer (VP/CIO)** oversaw the Information Technology function**,** which employed 44 individuals, including one director, and consisted of five divisions: Quality Assurance, Data Management, Records & Information Management, Systems, and Database Administration.

- The **VP/General Counsel** oversaw the Legal Services function, which employed 22 individuals, including two directors, and consisted of three areas: Legal Services, Legal Claims, and Special Investigations.

- Two additional positions report directly to the Manager, but were not considered as VPs of a particular area. These positions include the Director of Human Resources (HR) and the Senior Internal Auditor.

  - The **Director of HR** headed the HR Department, which consisted of three positions: Senior HR & Corporate Wellness Specialist and two staff members.

  - The **Senior Internal Auditor** oversaw a staff of one (the Internal Auditor). Administratively, the Senior Internal Auditor reported to the Manager on a day-to-day basis; however, the position formally reports to the Board. On October 9, 2018, the Board moved to revise the Senior Internal Auditor position title to Director of Internal Audit and adjust his pay according to the new pay structure based on recommendation of an outside consultant.

Roles of Manager and Board

While KRS 342.811 and 342.813, respectively, outline the powers and duties of the Board as well as the Manager, there appears to be a difference of opinion as to how these roles should be executed. Much of the misunderstanding stems from the fact that Board members appointed by the Governor serve a term of four years, while KEMI has had only two Managers since it was established in 1994. The ever-changing nature of Board membership, coupled with the contrast in personalities and experiences of those collective members, can lead to differing approaches to executing governance. In particular, a review of Board and committee meeting minutes, as well as a series of interviews with Board members and KEMI staff, indicated that budgeting, salaries and benefits, and procurement were the three functions most often in dispute.

The Board Does Not Approve Individual Contracts

According to statute, the Board shall examine and adopt an annual operating budget for KEMI, while the Manager is responsible for recommending a budget and then directing and controlling all expenditures of the approved budget. The current process calls for KEMI staff to create the budget with little to no involvement from the Board. The VP/CFO presents the upcoming year's proposed budget to the Board in October, with the document being sent to Board members typically one week prior to the meeting for review. Some Boards have requested and received the detail behind the proposed budget amounts, while other Boards have requested only a high-level detail of the budget. The current Board has expressed an interest in becoming more involved in the budget development process moving forward than in years past. Regardless of the historical approach to governance, KEMI would benefit from frequent communication between the Board and the Manager about expectations.

According to the Manager, the Board's duties are spelled out in statute which includes oversight, governance, strategic direction, and policy setting. The Manager explained his role at KEMI as making recommendations to the Board and providing anything needed to aid in the decision-making process. He described the results as, "here's where KEMI is headed, go carry it out" and indicated he tries to be transparent as well as reponsive to the Board. While the Manager did not indicate a change in roles has occurred over the last few years, he did note there is a different philosophy of governance among the Boards. For example, previous Boards did not feel it was necessary to approve individual contracts as they already approved the operating budget and will receive monthly budget reports; however, the current Board wishes to see all contracts.

KRS 342.811(17) states the Board shall "[a]pprove all contracts entered into by the authority, in accordance with the bylaws and procurement policy of the board." The Bylaws allow the Board to delegate authority to the Manager "to enter into any contract or execute and deliver any contracts or other instruments in the name of and on behalf of KEMI"; however, a written delegation authorizing the Manager to enter into contracts on behalf of KEMI has not been documented. When auditors asked the Manager if the delegation is documented in writing, the Manager stated, "I don't think so…I think it was implied," except to say that he was "given authority to purchase land" by the Audit Finance Investment Committee of the Board, as discussed in Finding 3 (page 28). Due to the transition of Board members and different procurement policies and methods, such transfer of power should have required not only written documentation, but also a reevaluation of the delegation of authority on a periodic basis to ensure all Board Members are aware of the authority provided to the Manager.

During the Board Meeting on October 9, 2018, the Board, based on the recommendation of the Bylaws and Legislative Relations Committee, adopted revisions to the Bylaws to make the contract section consistent with the recently revised procurement policy. The ability to delegate authority from the Board to the Manager regarding contracts was replaced with a simple statement indicating that "[t]he authority of KEMI to enter into contracts is governed by the procurement policy currently in force." The revisions to the procurement policy, also approved by the Board at the October 2018 meeting and effective January 1, 2019, require all contracts be presented to the Board.

The Manager Terminated KEMI's Actuary without Board Approval

Another example of how the role of the Board versus the Manager was questioned involved the termination of a contract by the Manager without prior approval by the Board. Although not documented in Board meeting minutes, the Manager believes he and the Board had quite a bit of discussion regarding KEMI's actuary. Additionally, the Manager says he was in consistent contact with the now former Board Chairman/Audit Finance Investment Committee Chair in the time leading up to the termination of KEMI's actuary. According to the Manager, time did not allow waiting for the next scheduled meeting to terminate the actuary and begin the process of hiring a new actuary. "The full Board did not approve the termination of the actuary," the Manager stated, but the former Board Chairman gave him verbal approval to terminate the actuary. As discussed in Finding 1 (page 10), a Board Chairperson has no authority other than to chair meetings of the Board and appoint committee members, and has no separate authority to approve such termination. At the next Board Meeting on September 6, 2017, the Board appointed a new actuary and did not approve the termination of the former actuary. Although roles and authority regarding the contract termination process are not specifically addressed in state law, Bylaws, or KEMI policy, the Manager stated, "I would say it is the Board's responsibility to terminate." However, such action was not documented as having occurred.

The KEMI Manager terminated an actuary without Board approval.

In each of these examples, better communication of expectations and reevaluation of an implied delegation of power would have greatly benefited KEMI by decreasing the chances for misunderstandings regarding roles and authorities. The contrast in length of service between the Board and the Manager naturally creates the need to clearly document, and to periodically repeat discussions, concerning roles, authorities, and responsibilities of the two parties in order for all parties to have consistent expectations.

An Unbudgeted Expenditure Exceeding $50,000 Was Not Brought to the Board as Required by Policy

KEMI's Procurement Policy requires unbudgeted expenditures exceeding $50,000 be presented to the Board for approval. However, expenditure testing identified an unbudgeted marketing expenditure of $109,000 that was not presented to the Board for approval. In July 2016, KEMI entered into an agreement with RASEP Sports Properties, LLC, who holds sales, marketing, and sponsorship rights for Rupp Arena, for advertising purposes. Though the Manager indicated that he and a former Board Chairman discussed the change in advertising strategy and believed it was discussed at a Board meeting, no such discussions regarding the expenditure appear to be documented in Board meeting minutes.

Recommendations

KEMI and the Board should consider dedicating a portion of their annual orientation to discuss expectations and prerogatives of the Board regarding their preferred approach to governance.

KEMI and the Board should evaluate, and consider adding to the Procurement Policy, methods for termination of contracts and the appropriate level of involvement of the Board.

We recommend KEMI ensure unbudgeted expenditures exceeding $50,000 be presented to the Board for approval consistent with KEMI policy. Furthermore, KEMI should ensure presentation to and approvals by the Board are properly reflected in Board meeting minutes.

Report continues with Finding 3 on next page.

Finding 3: The Strength of KEMI's Procurement Policies Has Declined

According to KRS 342.811, the board is to adopt a procurement policy consistent with KRS Chapter 45A. However, no guidance is provided as to what "consistent with" means. As the statute currently reads, it is unknown whether KEMI's procurement policy should mirror KRS 45A word for word or should only uphold the spirit of KRS 45A, not the exact language. Major deviations from substantive provisions of KRS 45A are noted in this finding. These departures from state law include higher thresholds for competitive bidding and for transparency of personal service contracts. They also include non-competitive practices related to existing contracts, and de facto policy changes by management not approved by the Board.

KEMI Procurement Policy Chronology

Since 1998, there have been five revisions of the KEMI Procurement Policy, two of which were in effect between January 1, 2016 and April 30, 2018, when many contracts and expenditures reviewed as part of this examination were initiated. Figure 3 (below) provides examples of key changes made to the KEMI Procurement Policy over time, demonstrating a decline in rigor. These four areas—Small Purchase Authority, Competitive Bidding, Personal Service Contract review by GCRC, and Contract Extensions—are discussed further in this finding.

> KEMI increased its small purchase authority from $10,000 to $50,000 between 1998 and 2014.

Report continues with Figure 3 on next page.

Figure 3: Summary of Select Procurement Policy Revisions Made Between 1998 and 2019

Policy Date	Small Purchase Authority	Competitive Bidding	Personal Service Contract	Extension of Contracts
April 15, 1998	Cost of Purchase: / Quotes: < $1,000 — 1, verbal or written $1,001 to $5,000 — 2, verbal or written $5,001 to $10,000 — 3 written	Will be used for procurement of capital construction, products or services more than $10,000.	Filed with GCRC pursuant to KRS 45A.690. Contract cost not exceeding amount in KRS 45A.700 are exempt from review by subcommittee.	Allowable for any given period of time; usually in one (1) year intervals.
September 1, 2011	Cost of Purchase: / Quotes: < $5,000 — 1, verbal or written $5,001 to $10,000 — 2, verbal or written $10,001 to $20,000 — 3 written	May be used for procurement of supplies on an annual basis over $20,000.	PSC exceeding $40,000 on an annual basis shall be filed with GCRC. If GCRC disapproves **the Manager or his designee** shall determine whether PSC will be revised, cancelled or entered into.	Allowable for any given period of time; however, no suggestion of a standard extension period.
July 1, 2014	Cost of Supply: / Quotes: < $25,000 — 1, verbal or written $25,000 to $50,000 — 2, verbal or written Cost of Service: < $20,000 — 1, verbal or written $20,000 to $30,000 — 2, verbal or written	May be used for procurement of supplies on an annual basis over $50,000.	No change in GCRC reporting from prior version.	No change in this section of the policy from prior version.
April 25, 2017	No change in Small Purchase Authority from prior version.	No change in application or cost amount from prior version.	No change in GCRC reporting from prior version.	No change in this section of the policy from prior version.
January 1, 2019	Cost of Supply: / Quotes: < $25,000 — 1, verbal or written $25,000 to $50,000 — 3, verbal or written Cost of Service: < $20,000 — 1, verbal or written $20,000 to $30,000 — 3, verbal or written	No change in application or cost amount from prior version.	PSCs exceeding $10,000 on an annual basis shall be filed with GCRC. If LRC disapproves, **the Board** shall determine whether PSC will continue.	No change in this section of the policy from prior version.

Source: APA, based on KEMI Procurement Policies, effective: April 15, 1998, September 1, 2011, July 1, 2014, April 25, 2017, and January 1, 2019. Gray highlighted rows in Figure 3 identify versions of KEMI procurement policies in effect during the examination period (between January 1, 2016 and April 30, 2018).

As noted in Figure 3 (above), at one time KEMI procurement policies contained significantly lower thresholds for competitive bidding, required three written quotes once small purchases reached a certain amount, and directly referenced KRS 45A.690 and KRS 45A.700 when discussing submission of PSCs to GCRC for review. In 2011, the thresholds for small purchases and competitive sealed bidding began to increase, references specific to KRS 45A.690 and KRS 45A.700 were removed, and authority was given to the KEMI Manager to determine whether a PSC would be revised, cancelled, or entered into if GCRC disapproved the contract after review. In 2014, KEMI significantly increased its thresholds for competitive bidding, made a distinction between small purchase of supplies and services, and entirely removed the requirement for three written quotes. Recently, KEMI revised its policies to give the Board authority to determine whether a PSC will continue if disapproved by GCRC, rather than the Manager, and KEMI has increased the number of quotes needed for supplies and services costing a certain amount. While revisions have been made, those revisions have not completely reverted to the prior policies that were more competitive.

What Does "Consistent With" Mean?

KRS Chapter 45A applies to "every expenditure of public funds by this Commonwealth" per KRS 45A.020. In creating KEMI, the General Assembly stated its intent was to "establish a self-supporting competitive state fund." KRS 342.801(2). KEMI funds are policyholder funds rather than public funds. KRS 342.803(1) created KEMI as a "municipal corporation and political subdivision" of the Commonwealth.

Auditors have outlined the following possible approaches for KEMI procurement policies pursuant to KRS 342.811. Unless there is litigation or further clarifying legislation, the correct approach is perhaps debatable.

<u>Approach 1. KEMI is subject to KRS Chapter 45A, regulations promulgated thereunder, and Finance and Administration Policies (FAPs), all in their entirety</u>. The most restrictive interpretation of the statute would give the KEMI board the power to only adopt KRS 45A intact, without deviation. By implication, but not by reference, one could argue that the regulations interpreting and implementing KRS 45A would also apply to KEMI. However, under this approach, the KEMI board has little authority other than to perhaps flesh out some processes not otherwise covered by KRS 45A, or by regulation or an FAP.

<u>Approach 2. KEMI follows KRS Chapter 45A, and adopts internal policies that take the place of FAC regulations</u>. The Finance and Administration Cabinet [FAC] Secretary promulgates regulations "*consistent with* [KRS 45A] governing the purchasing, management, and control of any and all supplies, services, and construction, and other items required to be purchased by the Commonwealth." KRS 45A.035(1) (emphasis added). This authorizes FAC to enact regulations that are not verbatim recitations of KRS 45A, but that do not contradict KRS 45A in substance. Given the similar "consistent with" language in KRS 342.811 and KRS 45A.035(1), this approach would infer that KEMI is given the same authority for its own organization as the FAC Secretary has for state government. The KEMI internal policies take the place of FAC regulations and FAPs. Just as FAC cannot adopt regulations that contradict KRS 45A, KEMI policies cannot contradict KRS 45A—meaning that KEMI cannot expand bidding thresholds or other substantive provisions.

<u>Approach 3. KEMI adopts its own procurement policies that are in the spirit of KRS 45A, but may be less restrictive</u>. This is the approach KEMI has followed in recent years, making its procurement policies less stringent than KRS 45A.

With respect to approach 1, the General Assembly could have made KRS 45A applicable to KEMI directly, but instead chose to require KEMI to adopt internal policies "consistent with" that chapter. This approach suggests the KEMI procurement policies are something different than KRS 45A. Furthermore, auditors can find no authority to state that KEMI is required to follow regulations promulgated by FAC or FAPs, because those regulations are not referenced in KRS Chapter 342. The fact that the statute says "KRS Chapter 45A, including competitive bidding procedures" leans toward something less than KRS 45A adopted intact, because then there would be no need to refer to "competitive bidding procedures" that come as part of the KRS 45A package if kept intact.

Approach 3 is criticized in this report for not being consistent with KRS 45A in several important respects. The General Assembly could have required KEMI to create its own competitive bidding process or generic procurement rules, but instead chose to specifically reference KRS 45A. Therefore, we recommend that KEMI strengthen its procurement policies in at least four key respects. KEMI must also consistently follow any procurement policies it adopts, which is addressed in other chapters of this report.

Competitive Bidding Thresholds Have Increased

KEMI's small purchase authority and competitive bidding thresholds are higher than those used by other state and local government entities and vary depending on whether the purchase is of supplies or services. For example, KEMI policy allows procurements of supplies that cost less than $25,000, and services that cost less than $20,000, to be procured by obtaining one verbal or written quote. Two verbal or written quotes are required for supplies that cost between $25,000 and $50,000, and services that cost between $20,000 and $30,000. Conversely, the Kentucky Finance and Administration Cabinet requires one quote for services or supplies that cost $5,000 or less and three quotes for services or supplies that cost between $5,000 and $40,000. As demonstrated in Figure 4 (below), only Kentucky's Higher Education Institutions and the Legislative Branch have higher small purchase authority limits than KEMI requiring one quote.

KEMI's competitive bidding threshold of $50,000 for supplies is the highest threshold, only equal to that of the Administrative Office of the Courts (AOC). In a 2018 special examination, the APA recommended that AOC reassess its competitive bidding threshold. According to AOC's web page created to show its progress regarding APA's recommendations, the bidding threshold has not been changed. Additionally, KEMI policy regarding competitive sealed bids is not strictly required for supplies and does not apply to services. Rather, KEMI policy in effect as of April 30, 2018, states, "[w]hen the Competitive Sealed Bidding process is either not practicable or not advantageous to KEMI, competitive negotiations may be used to purchase supplies on an annual basis over fifty thousand dollars ($50,000) or services over thirty thousand dollars ($30,000)."

Report continues with Figure 4 on next page.

Figure 4: Non-Construction Small Purchase Limits Comparison, as of 4/30/2018

Government Type	One Quote	Three Quotes	Competitive Bidding
Local Governments	$20,000 or less	N/A*	more than $20,000
State Agencies (statutory minimum)	$1,000 or less	N/A*	more than $1,000
State Agencies (actual delegated range depends on agency)	less than $5,000	$5,000 to $10,000 or $5,000 to $20,000	more than $10,000 or more than $20,000
Finance and Administration Cabinet	$5,000 or less	$5,000 to $40,000	more than $40,000
Higher Education Institutions and Legislative Branch	$40,000 or less	N/A*	more than $40,000
Administrative Office of the Courts	$1,000 to $10,000	$10,000 to $50,000	more than $50,000
KEMI Supplies	less than $25,000	$25,000 to $50,000**	more than $50,000
KEMI Services	less than $20,000	$20,000 to $30,000**	not applicable

*Subject to internal policies.
**Only two verbal or written quotes required.
Sources: KRS 424.260; KRS 45A.385; KRS 45A.100(1); Finance and Administration Cabinet Small Purchase Authority Delegations and Quotation Limits, effective July 5, 2017; Kentucky Court of Justice Purchasing Guidelines, effective January 2011; and KEMI Procurement Policy, effective April 25, 2017.

In October 2018, revisions to the KEMI procurement policy were approved by the Board to be effective January 1, 2019. The revisions approved by the Board do not lower these thresholds; however, the number of verbal or written quotes required prior to the purchase of supplies that cost between $25,000 and $50,000, and services that cost between $20,000 and $30,000, was increased to three.

Standing Determinations Are De Facto Revisions to Procurement Policies

In some instances KEMI provided generic “standing determinations” to support corporate legal service contracts. Standing determinations are general written determinations, which KEMI has used to justify certain non-competitive procurements. These determinations do not generally relate to a specific vendor or time period but rather relate only to a specific type of service.

These generic determinations are, in essence, the KEMI Manager establishing KEMI’s policy regarding legal service procurements. As statute requires the KEMI Board of Directors to approve the procurement policy, these written determinations should go before the Board. It is more transparent for the KEMI procurement policy to be revised by the Board than it is to use standing determinations in lieu of an official policy change.

KEMI indicated they have used three "standing determinations" in the past for legislative agents, corporate legal services, and technical support for IT software/hardware. Standing determinations for corporate legal services are further discussed in Finding 5 (page 35).

"Extension Contracts" Allow No-Bid Contracts to Existing Vendors

KEMI's policy regarding what it calls "extension contracts" allows for non-competitive awards to existing vendors. This policy should be eliminated. According to the KEMI Procurement Policy adopted April 25, 2017: "Extension contracts are contracts that extend the duration of the existing contract. Contracts may be extended for any given period of time. When this occurs an extension agreement will be signed by the contractor and KEMI." Extending the duration of an existing contract beyond the period called for in the original procured contract is legally a new contract. As Kentucky's highest court explained in De Jernette V. Fidelity & Cas. Co. of New York, 33 S.W. 828, (Ky. 1896).

> We have no doubt that each renewal of the policy was a new contract. Each was upon a new consideration, and was optional with both parties. At the expiration of the year over which the original policy extended, the obligation of the insured was ended, and it was only by the occurrence of the will of both parties that the obligation could be continued.

Id. at 829 (quoting Brady v. Insurance Co., 11 Mich. 425 (1863)). The Court found that the renewal was a "separate and distinct contract" even where the renewed contract had the "same terms and conditions." Id.

The KEMI policy further states that "[i]f there are any changes from the original contract, the extension agreement will clearly state the differences and the new terms of the contract." With no limitation on what terms may be modified, these provisions allow KEMI to create a new contract with an existing vendor with different terms, all without competitive bidding or advertising.

KEMI policy allows it to enter into contracts with existing vendors without competitive bidding.

Government Contract Review Committee Reporting Lapses

Finding 6 (page 38) addresses KEMI's failure to follow its own policy to report contracts to the Government Contract Review Committee. While the reporting is a good transparency measure, the primary check on KEMI contracts is board approval.

Recommendations

We recommend the KEMI Board, in consultation with its legal counsel, revise its procurement policy to be more aligned with the substantive provisions of KRS Chapter 45A outlined above. If there is significant dispute about the correct approach to procurement policies, KEMI may consider requesting clarifying legislation regarding KRS 342.811. Furthermore KEMI should not allow renewal of existing contracts beyond the term and renewal periods under which the contracts were originally procured.

Report continues with Chapter III on next page.

Chapter III: Internal Control Lapses

Finding 4: KEMI Paid a Broker $38,825 More than Agreed and Paid $10,000 Before Services Were Fully Rendered

> Without Board approval, KEMI paid a broker $38,825 more than originally agreed upon in a no-bid contract. A contract for the additional payment was not signed by an authorized party.

KEMI selected a broker for the purchase of land through a non-competitive process then paid the broker $38,825 more than what was originally agreed to in a March 1, 2015 contract. KEMI justified the additional compensation by developing a new agreement on May 4, 2016, indicating that the original contract fee of $10,000 was an advance. In accordance with KEMI's procurement policy, because the total amount paid to the Broker was just under $50,000, the contract associated with this unbudgeted expenditure was not presented to the Board for approval. The May 4, 2016 agreement was negotiated by the KEMI Manager and signed by the KEMI Special Investigations Unit (SIU) Director, who did not have authority to enter into a contract of this amount on behalf of KEMI. Additionally, KEMI paid the Broker the initial $10,000 before all services associated with the original March 1, 2015 agreement were provided. The process for selecting and compensating the broker lacks transparency and raises concerns regarding the appropriateness of the transaction.

Non-Competitive Procurement

During the Board of Directors meeting on August 26, 2014, KEMI's Investment Policy was amended to allow the purchase of real estate with the intent to construct a new home office as explained in Finding 1 (page 10). According to KEMI personnel, the search for property began internally with management before the KEMI Manager and Director of Special Investigations Unit (SIU) identified Barry Mangold, Mangold Real Estate, as the agent of a potential property. After discussions, it was determined Mangold would be able to confidentially assist KEMI in finding and purchasing property resulting in the Confidentiality & Non-disclosure Agreement signed on February 20, 2015. Additionally, on February 20, 2015, the Manager signed a Procurement (Written) Determination for Mangold Real Estate indicating conditions exist to purchase by non-competitive negotiation.

The following excerpt defines the conditions that the KEMI Manager stated existed to justify using a non-competitive negotiation process:

> It is in the best interest of KEMI to determine whether there are properties available that can meet KEMI's needs for construction of facilities confidentially, prior to discussions with the current landlord about the possibility of vacating the Lexington Finance Center. Barry Mangold, Mangold Real Estate, is a real estate broker with many years of experience doing business in the [sic] Fayette County and Central Kentucky. As he is a sole proprietor, he has a greater ability to maintain the necessary level of confidentiality.

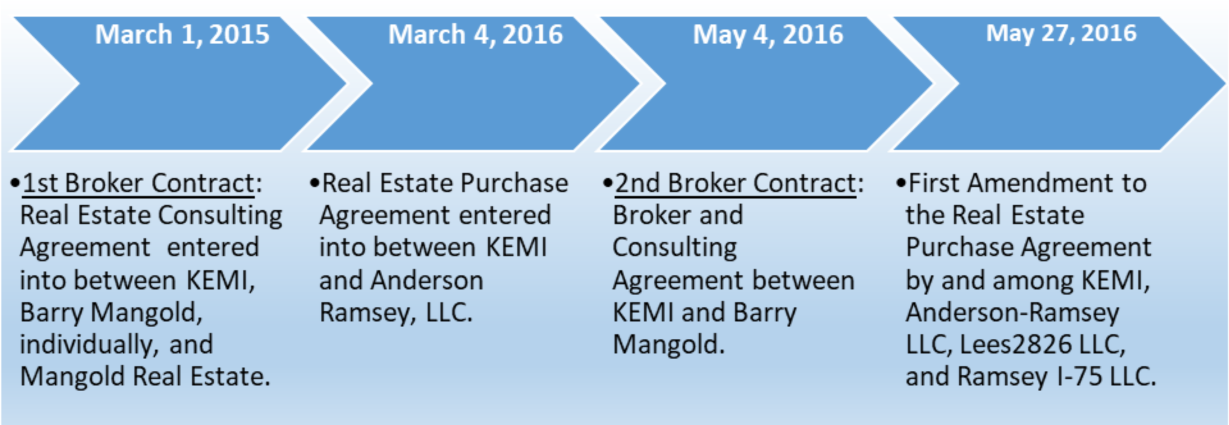
Confidentiality and the Broker's years of experience in the local market appear to be the two key elements of this determination. The KEMI Manager noted that before selecting Barry Mangold, he spoke with a representative of another local commercial realtor, Coleman Group, to opine on whether Mangold would be a good option for KEMI. The KEMI Manager noted that the Coleman Group was previously engaged to perform the same property search years prior but the Board, at that time, had determined not to proceed with a search. It is difficult to defend the use of a non-competitive negotiation process when KEMI contacted another potential commercial realtor, in the same market, to discuss the possibility of using the Broker to locate property. Additionally, Kentucky Professional Licensing online licensee database identifies Mangold became affiliated with the Coleman Group on May 28, 2015, over three months after the written determination was issued, indicating that he was no longer a sole proprietor.

Further complicating the matter, the KEMI Manager acknowledged knowing the Broker prior to selecting and engaging Barry Mangold, Mangold Real Estate, in business with KEMI. The KEMI Manager stated that the Broker is from his hometown, the two have mutual acquaintances, and both had kids competing in high school athletics at the same time. However, the KEMI Manager stated that they are "not running buddies" and while they would occasionally see each other at events and speak, they do not socialize. The KEMI Manager's prior association with the broker, coupled with the non-competitive procurement process and timeline of the broker payments and contracts, raises a question as to whether a conflict may have existed influencing these business decisions.

Timeline of Broker and Property Purchase Agreements

Figure 5 (below) is an abbreviated timeline of KEMI Broker and Property Purchase Agreements following the KEMI Manager's determination to follow a non-competitive procurement process in the selection of Barry Mangold, Mangold Real Estate, to serve as KEMI's broker on February 20, 2015. For a more detailed timeline of events, see Appendix D: Expanded Timeline of KEMI Real Property Procurement.

Figure 5: Timeline of KEMI Broker and Property Purchase Agreements



Source: APA, based on KEMI records.

Two Broker Service Agreements

Initially KEMI provided auditors one agreement with Mangold, the Broker and Consulting Agreement effective May 4, 2016, which references payment of "additional services not compensated by the 2.5% commission." In an effort to determine what these additional services included, KEMI told auditors a Real Estate Consulting Agreement effective March 1, 2015, was mistakenly not uploaded with other documents provided in the initial request.

The KEMI Manager stated the former General Counsel drafted the Real Estate Consulting Agreement effective March 1, 2015, and the law firm engaged in connection with the purchase of property (Rose Grasch Camenisch Mains, PLLC) drafted the Broker and Consulting Agreement effective May 4, 2016. While the Broker and Consulting Agreement and the Real Estate Consulting Agreement contain similar services, the description of the services to be provided are not identical; however, the first agreement indicates the services to be provided are not limited to the services listed in the agreement. Furthermore, the Broker and Consulting Agreement includes additional compensation from the original agreement amount of $10,000 listed in the Real Estate Consulting Agreement. Figure 6 (below) provides a comparison of the services and compensation outlined in each of the agreements.

Figure 6: Mangold Real Estate Agreement Comparison

Real Estate Consulting Agreement effective March 1, 2015	**Broker and Consulting Agreement effective May 4, 2016**
1. Services.	1. Services.
Mangold will provide real estate consulting and development services, including but not limited to the following: a) analysis and advice on the availability of and suitability of property to suit KEMI's business needs, b) recommendation as to location selection, c) assistance with negotiation of the business terms of any purchase contract, and d) confer, coordinate and work with other professionals engaged by KEMI in connection with the purchase of property, including appraisers, environmental consultants, surveyors, architects, engineers and contractors.	a) Broker hereby agrees to advise and assist KEMI in its continued negotiation with Seller respecting purchase of the Contracted Property, including the terms of amendment(s) to the purchase contract, and advise KEMI respecting its due diligence of the Contracted Property. b) Broker agrees that if KEMI does not close on the purchase of the Contracted Property that Broker will continue to identify for KEMI other prospective properties that satisfy KEMI's requirements and, if KEMI requests, advise and assist KEMI in the negotiations for the purchase of other real property, including evaluating and determining appropriate purchase price

	and other contract terms and assistance with due diligence thereon.
2. Compensation.	2. Compensation.
Mangold will receive, as compensation for its services under this Agreement, fees in the amount of $10,000.	a) KEMI agrees to compensate the Broker for the Services an amount equal to one percent of the purchase price paid by KEMI for the property purchased by KEMI (the “Fee”). Such Fee shall be in addition to the two and one-half percent purchase price commission to be paid by Seller for the Contracted Property upon closing. In the event Broker is paid more than two and one-half percent (2.5%) of the purchase price by any seller, including Seller, the Fee shall be reduced by the amount by which the commission paid by such seller exceeds two and one-half percent (2.5%) of the purchase price. For example, if a seller paid a commission to Broker of three percent (3%) of the purchase price, then the Fee to be paid by KEMI hereunder would be one-half of one percent (0.5%). If Broker receives a commission in excess of three and on-half (sic) percent (3.5%) of the purchase price of property from any seller, Broker shall to the extent of such excess repay KEMI any advances of the Fee made by KEMI to Broker. b) Except for the advances provided below, the Fee shall not be due or owing until delivery to KEMI of the deed to the applicable real property. c) KEMI has paid Broker a $25,000 advance in two separate payments on the Fee in recognition of the level of Services previously provided. This advance will be recouped against any Fee payable by KEMI, but if non-refundable except as provided above. d) Broker shall be responsible for negotiating any commission above the Fee with any Seller of real property to KEMI and KEMI shall have no liability therefor.

Source: APA, based on KEMI Real Estate Consulting Agreement with Barry Mangold and Mangold Real Estate effective March 1, 2015; KEMI Broker and Consulting Agreement with Barry Mangold effective May 4, 2016

The May 4, 2016, agreement states that KEMI has paid the Broker a $25,000 advance of this agreement. KEMI indicates that the $10,000 paid in association with the March 1, 2015 Consultant Agreement on December 2015 is part of that advance and part of the 1% additional compensation KEMI agreed to pay through the May 4, 2016 agreement. The March 1, 2015, Consulting Agreement never indicates additional compensation is anticipated or that the $10,000 fee is a planned advance payment on other services. Instead, KEMI management agreed to pay more money to the broker, and created a document to justify paying the additional compensation after the fact.

Upon inquiry KEMI stated, "Mangold provided a full array of real estate consulting services which began in February 2015 and ended at property closing on [September 9, 2016]. The services provided would include all services listed in both agreements." In discussing the May 4, 2016 agreement with the KEMI Manager, he noted that the price of the property identified was $6 million and that the Broker was able to reduce the price to $4.8 million. The Real Estate Purchase Agreement dated March 4, 2016, identifies the agreed purchase price as $4,882,500. Section 11 of the purchase agreement states that the Seller "shall be responsible for paying all customary and reasonable fees and commissions owed to Buyer's broker." The Manager confirmed that it was assumed at the time of negotiations that the Broker would be paid by the Seller; however, because the Broker negotiated the price so low the Seller reduced the amount they were willing to pay as commission to Mangold.

On May 27, 2016, a first amendment to the Real Estate Purchase Agreement was signed stating, "Seller hereby confirms for Buyer that Seller has agreed, at Closing, to pay Buyer's broker, Barry Mangold, a commission equal to 2.5% of the Purchase Price." The amendment to the purchase agreement modified Sections 7 and 9 of the original purchase agreement; however, all remaining "terms, covenants, conditions and provisions" of the initial purchase agreement, including Section 11, are still in "full force and effect." By specifically stating the Seller will pay 2.5% to the broker in the amendment and not amending Section 11 of the original purchasing agreement, KEMI in essence agreed that 2.5% is a customary and reasonable commission. However, the KEMI Manager stated that that he and the SIU Director had researched commission prices and determined 3% was fair, so they offered the Broker an additional 1% over the amount the Seller paid. The KEMI Manager noted that the Broker was involved until the close on the property and that the additional services provided by the Broker included services of restrictions and covenants.

Contract Approval Process

The KEMI Manager signed the Real Estate Consulting Agreement dated March 1, 2015. The SIU Director signed the Broker and Consulting Agreement, dated May 4, 2016. The second contract compensated the Broker up to 1% of the property purchase price, equaling $48,825. However, the SIU Director did not have written authority to approve a contract on behalf of KEMI of this amount for these services. KEMI records show the SIU Director had a small purchase authority of $10,000 in the SIU budget unit and some authority in spending budgeted funds for equipment and building maintenance, repairs, and leasing at the time the second broker agreement was established. The KEMI Manager did not recall the circumstances leading to the SIU Director signing the second broker agreement, stating that he may have been traveling but he was certain he and the former General Counsel were aware of his actions at the time the contract was signed. On February 15, 2019, KEMI Director of Internal Audit submitted to the APA a travel voucher showing the KEMI Manager left on an out-of-state conference trip on May 4, 2016. Although the KEMI Manager may have been in travel status on that date, KEMI signature authority identifies several other executives with the authority to have signed the contract.

The SIU Director was primarily responsible for the administration of the property search and assumed that was the reason he signed the May 4, 2016, Broker and Consulting Agreement. The SIU Director stated he was comfortable signing the agreement as he recalled signing other contracts related to the property purchase as well, such as contracts for geo-tech and engineering services. Review of a sample of KEMI contracts identified a construction contract valued at $49,885 issued on June 12, 2017, also signed by the SIU Director on behalf of KEMI supporting the SIU Director's statement regarding his approval of other contracts. Again, based on his designated small purchase authority limit, the SIU Director did not have the authority to approve a contract of this amount.

Although the SIU Director signed the second broker agreement, he stated he was not involved in the negotiations leading to the Broker and Consulting Agreement. He explained negotiations resulting in the May 4, 2016 agreement were handled by the KEMI Manager, the Broker, and the Seller. The SIU Director believes the 3.5% total commission paid to the Broker by KEMI and the Seller is within an acceptable industry range but stated that he had not researched the industry standard for broker commissions until more recently when questions were first raised by others regarding the land purchase.

Ultimately, KEMI paid the Broker $10,000 on December 22, 2015, $15,000 on May 4, 2016, and $23,825 at closing, for a total of $48,825. Because the full amount of the payment to the Broker was less than $50,000, KEMI policy did not require the expense to be presented to the Board for approval. The KEMI Manager stated that he had discussed the matter with the Chairman but did not go to the full Board for approval. As noted in Finding 1 (page 10), the full authority of the Board does not reside in the individual holding the position of Board Chair. Although the KEMI Manager may have had the authority to enter into this agreement based on the organization's policy, he acknowledged that he could have better communicated the broker transaction to the Board. As discussed in Finding 6 (page 38) of this report, the broker services contract also did not go before GCRC despite the policy requirement.

Payment Before Services Were Rendered

KEMI paid Barry Mangold the full $10,000 agreed to in the March 1, 2015 agreement on December 22, 2015, before all services associated with the Broker's contract were completed. Specifically, the KEMI Manager noted that Mangold began negotiations with the seller after the Board approved the Real Estate Purchase Agreement, which was approved in the February 9, 2016 Board meeting. Negotiation of the business terms of any purchase contract are part of the services to be provided under the Real Estate Consulting Agreement in effect on March 1, 2015.

Recommendations

We recommend KEMI ensure contract revisions, modifications, or supplements clearly reference back to the original contract and that it is clearly identified which specific terms, covenants, conditions or provisions are added, deleted, modified or remain unchanged.

Additionally, we recommend KEMI reconsider the criteria by which it is determined the information brought back before the board for approval or for informational purposes. While a monetary threshold may be appropriate in most cases, consideration should be given to bringing information to the Board when concerns may exist regarding special procurements such as those procured through a non-competitive negotiation.

Report continues with Finding 5 on next page.

<u>Finding 5: KEMI Did Not Consistently Create Written Determinations as Required by its Procurement Policy</u>

KEMI did not consistently follow its own procurement policy to procure supplies or services when the procurement method process requires written determinations. According to KEMI's Procurement Policies, the Manager or his designee will make a written determination after reviewing the request for written determination when conditions exist to procure through Sole Source Procurement, Emergency Procurement, or Non-Competitive Negotiation. Additionally, when procuring through competitive sealed bidding or competitive negotiation, policy requires a written determination by the Manager or his designee to support the correction or withdrawal of bids and cancellation of a contract. Requests for written determinations and the actual written determinations were not created or consistently documented. In some instances KEMI provided generic "standing determinations" to support corporate legal service contracts.

The two procurement policies effective between January 1, 2016 and April 30, 2018 outline three separate steps for the process to procure supplies or services through Non-Competitive Negotiations.

KEMI's Procurement Policy, effective July 1, 2014, states:

2. Process

a. Request for Written Determination

When the conditions exist for KEMI to contract or purchase through a non-competitive negotiation, a request for a written determination shall be made to the President/CEO or his designee.

b. Written Determination

Once the President/CEO or his designee has reviewed the request to purchase through non-competitive negotiation, he shall make a written determination. If he finds that the conditions exist for KEMI to purchase through a non-competitive negotiation, KEMI may proceed with the non-competitive negotiation. If he finds that the conditions do not exist for KEMI to purchase through non-competitive negotiation, KEMI will not purchase through a non-competitive negotiation.

c. Solicitations

Insofar as it is practical, no less than (3) quotations shall be solicited to submit written or oral quotations whenever it is determined that competition is not feasible. In addition, competition may be deemed not feasible, and quotations will not be required, in the following situations:

1. Procurement for services or supplies when no meaningful price competition exists;
2. Procurement for services or supplies where the rate is fixed by law or ordinance;

3. Procurement for a service that requires specific expertise or must be performed
   under strict time constraints such as attorney, certified public accountant, legislative agents, consultants, or any other licensed professional; or
4. Procurement for insurance.

As noted above, the Procurement Policy effective April 25, 2017, outlines the same three-step process to procure through non-competitive negotiation with additional detail. In the first step of the process, *a. Request for Written Determination*, the following sentence is added that states, "[E]ach request for written determination shall be well-supported and documentation of the decision making process shall accompany each written determination." Additionally, a fifth situation is added in the third step of the process, *c. Solicitations*, which states: "[5.] Procurement for services or supplies that are subscription based and that are purchased separately as modules from the same vendor and are combined as needed."

As evidenced in this finding, KEMI did not adequately maintain or document the request for written determination to the Manager or the written determinations and submitted multiple "standing determinations" as support of contracts reviewed.

Request for Written Determination Not Documented and No Written Determination Identified

In an inquiry to KEMI regarding how requests for written determination to the Manager are communicated, KEMI indicated requests came to the Manager through a small group at the executive or director level, but may have originated in a particular unit. Additionally, to assist the Manager in the decision-making process, a memo or other form of documentation typically was provided and there was always a meeting to discuss the situation before signing any written determinations. However, KEMI did not maintain the memo or other form of documentation, but advised the requestor may have maintained the documentation.

Nine out of 26 contracts established through Non-Competitive Negotiations between January 1, 2016 and April 30, 2018, had no documented request to the Manager for a written determination. Although no requests were documented, KEMI provided auditors with written determinations to support six of these nine contracts; however, five contracts were supported by "standing determinations," which are explained later in this finding. No written determination was identified to support the selection of three of these nine vendors as required by KEMI policy; however, comparison to KEMI Procurement Policy determined that one of these three contracts, a lease for real property, should have been procured through a Competitive Sealed Bidding process and solicited again when the initial term of the contract ends. As for the remaining two contracts, after additional follow-up with the agency, KEMI acknowledged that written determinations for those procurements should have been documented.

Generic Determinations That Are Not Time-Bound

KEMI's written determinations for corporate legal services are generic and not time-bound. In an initial request, KEMI submitted the same generic "standing determination" dated July 3, 2014, as support for four separate corporate legal service contracts; however, after further inquiry concerning written determinations, KEMI identified two additional written determinations on file. While one determination dated June 15, 2015, was specific to one of the four contracts, the second written determination dated February 23, 2012 was another generic determination as KEMI indicated it was on file for two of the four corporate legal service contracts. In addition, KEMI did not document or provide the request for the written determination to the Manager as required by KEMI's Procurement Policy for the four corporate legal service contracts.

Recommendations

We recommend KEMI document and maintain in its records, all requests for written determinations presented to the Manager or his designee when the Procurement Policy requires such a request. See additional recommendations relating to KEMI record retention at Finding 9 (page 47).

We recommend KEMI follow a Competitive Sealed Bid process for its real property lease upon completion of the current contract term and KEMI maintain documentation consistent with a revised record retention policy, again see recommendations at Finding 9 (page 47).

We recommend KEMI eliminate the practice of creating "standing determinations" that are generic and not time-bound. KEMI should make all written determinations on a case-by-case basis.

Report continues with Finding 6 on next page.

Finding 6: Reporting to the Government Contract Review Committee Was Incomplete and Inaccurate

KEMI did not follow its policy requirement to submit all PSCs to GCRC of the Kentucky General Assembly for review. Also, KEMI submitted a multi-vendor PSC to GCRC for defense/legal counsel for claims with a firm charging more than the average rate identified in the contract and doing work not related to defense/legal counsel for claims. Until a recent revision to the KEMI procurement policy was made by the Board, policy allowed the KEMI Manager to override disapprovals of the GCRC. The requirement to submit PSCs for review promotes transparency and accountability in procurement practices.

KEMI's Procurement Policy governing Personal Service Contracts

KEMI's Procurement Policy effective on April 25, 2017, requires all personal service contracts (PSCs) exceeding $40,000 on an annual basis to be filed with the Government Contract Review Committee (GCRC) prior to service under the contract. If the GCRC disapproves of the contract, KEMI's Manager shall determine whether the personal service contract will be revised, cancelled, or entered into despite GCRC's disapproval.

Pursuant to the provisions of KRS 342.811, KEMI is required to adopt a procurement policy consistent with the state's procurement criteria, KRS 45A. KRS 45A.700, in part, states:

> Personal service contracts in aggregate amounts of ten thousand dollars ($10,000) or less during any one (1) fiscal year shall be exempt from routine review by the committee and shall be filed with the committee not more than 30 days after their effective date for informational purposes only. The committee shall examine all personal service contracts in aggregate amounts of ten thousand dollars ($10,000) or less submitted more than thirty (30) days after the effective date.

KEMI is required to adopt a procurement policy consistent with the above statute, but has amended its own procurement policy to set a higher threshold for submission to GCRC for approval.

Differences between KEMI Policy and KRS Chapter 45A

PSCs are contracts where an individual, company, or firm is to provide professional or administrative services for a specific period of time and agreed upon price. KRS 342.811 requires the Board to approve all contracts entered into by KEMI, in accordance with the bylaws and procurement policy of the Board. KEMI's procurement policy, in turn, is required to be consistent with the provisions of KRS Chapter 45A, which includes the requirement for the GCRC to review all personal service contracts.

Statutes concerning GCRC require that PSCs over $10,000 should be filed for approval with GCRC and PSCs under $10,000 be filed for informational purposes. KEMI's Procurement Policy during the exam period only required PSCs exceeding $40,000 annually to be filed with the GCRC for approval and PSCs under $40,000 to be filed for informational purposes. The former

VP/General Counsel stated that KEMI made a conscious decision to raise the threshold to $40,000 because it was more efficient for them and because they weren't using state money. The VP/CFO indicated that the change in threshold originated with KEMI.

KEMI's Procurement Policy also stated that if the GCRC disapproves or objects to a PSC, the Manager or his designee "shall determine whether the personal service contract shall be revised, cancelled, or entered into." This differs from KRS 45A.705, which states that such power lies with the secretary of the Finance and Administration Cabinet (FAC). According to the now former VP/General Counsel, the Manager has the authority in this case because KEMI has been delegated purchasing authority by the FAC secretary. The Manager indicated that he had never needed to invoke this authority to override the decision of the GCRC.

KEMI Failed to Submit Certain Contracts to GCRC

In the spring of 2018, the Board requested that KEMI's Senior Internal Auditor perform a procurement and contract review that would: review the procurement of products and services to ensure compliance with the established KEMI procurement policy; identify vendors paid for products or services to ensure they were providing a product or service in which KEMI has a legitimate business need; and evaluate internal contract administration processes and procedures to ensure they are adequate, efficient, effective, and meet business objectives.

Among other findings, the Senior Internal Auditor noted that PSCs were not filed with and approved by the LRC/GCRC for ten vendors in 2017. In addition, PSC informational copies should have been filed in 2017 for three additional vendors and another sixteen vendors were identified that will require additional review to determine if a PSC filing is required. "A process and procedural breakdown and/or lack of understanding of the filing requirements" were cited by the Senior Internal Auditor as explanation for failure of proper submittal to GCRC.

Because our exam period covered a larger period than that covered by the Senior Internal Auditor, auditors identified three additional PSCs that KEMI staff failed to submit for approval to the GCRC. First, a contract with Barry Mangold, Mangold Real Estate, provided real estate consulting services for the purchase of KEMI's new property at a total projected contract cost of $48,825. See Finding 4 (page 28) for discussion of the Barry Mangold contract. Also, the Allen Company Inc. provided land-clearing services in connection with KEMI's new property at a total projected contract cost of $49,885, and Rose Grasch Camenisch Mains PLLC provided legal representation to KEMI in connection with the purchase of real estate at a rate of $300 per hour for a total cost of $45,117.

Three contracts related to purchase of real estate were among those not submitted to the Government Contract Review Committee.

While the VP/General Counsel stated in June 2018 that some contracts "definitely should have been submitted and they weren't," she indicated that no decision had been made to not present particular contracts to GCRC, but that the process for determining what must be presented for approval was not as robust as it should have been. At least one other KEMI staff member echoed the VP/General Counsel's statement that a grey area exists as to what should and should not be submitted to GCRC for approval. In addition, the Manager readily admitted that KEMI had not always done a good job of knowing what went to GCRC, but at the end of the day "it doesn't really matter" because he had override authority. While the KEMI Manager would have the right to override a decision by GCRC, submission of PSCs to the GCRC promote transparency and accountability with contracting. After the exam period ended, KEMI staff met with FAC staff to obtain guidance about requirements, exemptions, and preferences involving PSCs submitted for approval.

KEMI repeatedly submitted a single personal service contract for multiple attorneys providing claims defense/legal counsel and stating the "average hourly rate for the vendors on this multi-vendor contract is $125." Identified within the multiple vendor PSC was Dinsmore & Shohl LLP. However, the hourly rate for this firm was in excess of the average rate by as much as $100 per hour. Additionally this firm did not provide defense/legal counsel for claims but rather provided legal services on more complex issues such as employment law and civil matters. For legal services in excess of the prescribed $125 an hour rate, the GCRC requires a submission of a letter detailing the need of the higher rate. KEMI did not provide such a letter prior to 2018.

Improvements Post-Exam Period

In October 2018, revisions to the procurement policy presented to and approved by the Board that addressed certain shortcomings in earlier policies. For example, the new policy, which took effect January 1, 2019, requires PSCs exceeding $10,000 on an annual basis, instead of $40,000, to be filed with GCRC for approval. The new policy also transfers the ability to override GCRC's disapproval or objection to the Board, instead of the Manager. Additionally, the new policy lists exceptions for what qualifies as a PSC, notes exceptions as to what types of general services and supplies do not require KEMI to issue a procurement, and removed the threshold by which procurements not presented in the original budget are to be brought to the Board for approval.

Recommendations

We recommend KEMI continue to evaluate its procurement policy on a periodic basis in order to add clarity and maintain consistency with KRS 45A.

We recommend KEMI keep its revised policy in place to submit, on a timely and consistent basis, any personal service contracts exceeding $10,000 to GCRC for approval.

Report continues with Finding 7 on next page.

Finding 7: Expense Reimbursements Were Incorrectly Coded

KEMI transactions were coded to budget accounts that did not accurately portray the activity conducted. Additionally, KEMI appears to have violated its Procurement Policy when it incurred an unbudgeted advertising expense of $109,000 without presentation of the expense to the Board for approval as required by policy. Accurate accounting of KEMI expenditures is important to control and direct spending, to effectively assess spending, and to ensure transparency and accountability to KEMI policyholders.

Benefits Coded to Accounts Other Than Benefits & Employee Relations Accounts

Review of KEMI budgets and budget variances found that some items KEMI identified as employee benefits are labeled as Rent or Salaries. The employee parking expenditure is included under the Rent expense category and was budgeted at $192,840, $208,800, and $196,740 for 2016, 2017 and 2018, respectively. Also, the annual Employee Incentive Plan (EIP) benefit, which may be awarded to employees based on performance evaluations or meeting certain strategic goals appears mislabeled, as it was categorized as a salary expense and was budgeted at $1,470,000, $1,400,000, and $1,600,000 for 2016, 2017 and 2018, respectively.

The Employee Parking benefit expense was budgeted for $208,800 in 2017. Parking is included with other expenditures as part of "Rent" expense. The Rent expense section total budgeted amount equaled $1,393,148, where $1,356,430 was actually expensed. The Employee Parking benefit expense was budgeted for $196,740 in 2018, although this benefit is included with other expenditures as part of "Rent" expense. The Rent expense section total budgeted amount equaled $1,373,148, where $348,007 has been expensed as of March 31, 2018.

According to KEMI's 2017 Budget, the EIP was allocated a budgeted amount of $1,400,000. Budgeted EIP expense is combined with KEMI salary expense for a total budgeted amount of $16,868,756, where $16,761,241 was actually expensed for salaries. KEMI attributed a majority of this variance to the attrition of staff in Claims, Underwriting, Systems, Application Development and open Call Director positions. Slightly offsetting this favorable variance is the EIP payout being more than anticipated.

EIP was allocated $1,223,285 in the 2018 budget. Again this benefit is combined with the salaries expense for a total budgeted amount of $18,520,536. As of March 31, 2018, $4,995,017 has been expensed. The 2018 EIP payments are awarded for the 2017 performance year. According to KEMI's HR Director, the 2018 EIP benefit will not be paid out in the spring of 2019. For more discussion of the EIP, see Appendix B: Employee Salaries, Benefits, and Other Perquisites.

Inconsistency in Coding Expenditures to Various Other Budget Accounts

Reviewing a sample of 107 expense reimbursements paid between January 1, 2016 and April 30, 2018 identified expense reimbursements for golf outings were incorrectly coded five times. In one of these five instances, the expense was coded to meals totaling $130. In the other four instances the golf outings were coded to seminars/conventions. The cost of these expenses totaled $642.40. KEMI acknowledged that the outings were not associated with a seminar or convention but rather were for business development purposes. KEMI stated that there is no business development code to which such expenses can be coded. However, business development is a component of KEMI's marketing and sponsorship plan, as such, it would be anticipated that such costs are coded to advertising. Additionally, testing of expense reimbursements identified $807.17 for door prizes and gift cards for an employee appreciation event coded to advertising rather than employee relations.

The meal budget code is considered a travel budget item; but, several meals that appeared to be related to business meetings, business development, and other employee relations were coded as travel meals. KEMI does not have a policy relating to meals outside overnight travel. There were six instances in which a reimbursed expense was coded as a meal when the actual expense was not a meal. Five of these six expenses were associated with employee relations, which included the purchase of ice cream to celebrate an employee's passing a licensing test, cakes for a retirement party celebration, gift cards for rewards and incentives, and cookies purchased for employee appreciation. The other expense clearly identified as being miscoded was a sponsorship to a local charity program. These expenses totaled $228.

Additionally, in two instances, reimbursement for a "meal" was actually a bar tab with no indication that food was purchased. These two tabs totaled almost $200. See Finding 8 (page 43) related for discussion of KEMI policy relating to alcohol expenditures. Additionally, testing identified other expenses that while technically were meals were not actually associated with travel.

Recommendations

We recommend KEMI develop its budget consistent with a strategic plan and ensure coding accurately portrays actual spending in support of that plan. For example, business development is an element of KEMI's Marketing and Communications' plan; therefore, expenditures associated with business development should be coded in a manner accurately identifying these expenses rather than coding expenses to meals or seminars and conferences.

We recommend KEMI and the Board continue to reevaluate their employee benefit package, as well as additional employee relations expenditures offered throughout the year, to determine if each type of expenditure is in the best interest of both employees and policyholders.

We recommend thoroughly reviewing the budget and budget-to-actual reports, to ensure awareness and consistency of budgeted amounts, in turn reducing errors. When critically analyzing the annual budget, ensure the amounts being spent are appropriate and related to business functions. Scrutinizing the budget in this way will help ensure the cost or expected amount per line item is offset by the potential benefits, resulting in a reduction or elimination of unnecessary expenditures.

CHAPTER IV: AREAS FOR IMPROVEMENT IN POLICIES AND OPERATIONS

Finding 8: KEMI Lacks Policies or Controls for Employee Expenses

Review of various KEMI expenditures and expense reimbursements made between January 1, 2016 and April 30, 2018, identified numerous control weaknesses in these processes, including a lack of detailed support to adequately document what was purchased, who attended events or meals, and the business purpose of the expense. Preapprovals are not obtained for all travel, in violation of policy. KEMI has provided no written guidance for when it is acceptable to incur the cost of meals outside of travel, for an acceptable amount of gratuity, or when it is appropriate to purchase alcohol. Establishing and implementing these controls would help to monitor and control spending of policyholder funds. Without providing some guidance and accountability, KEMI cannot ensure those funds are purposefully spent towards meeting the agency's overall goals and objectives.

Lack of Detailed Support

KEMI did not maintain adequate documentation to support all expenditures. Over a third of the 449 expenditures and reimbursements examined lacked adequate supporting documentation including detailed invoices, the purpose of the expense, event or sponsorship details, and the individuals attending or participating in events associated with the expense. Although KEMI provided information after inquiry regarding the purpose of the expenditures in question, without adequate supporting documentation an expenditure that serves an official business purpose may appear unreasonable or personal in nature. For example, KEMI purchased 150 dozen Nike RZN Tour Golf Balls at $37.50 per dozen from a country club in Western Kentucky for a total amount of $5,625. Until auditor inquiry to staff, KEMI did not document the purpose of the expense or how the golf balls would be distributed. Upon inquiry, KEMI staff described the expenditure as "Custom printed KEMI golf balls which were utilized as a promotional item used for business development for agents and policyholders or given to various charities as door prize giveaways." Despite the additional information KEMI provided to auditors following inquiry, 42 expenditures and 56 expense reimbursement transactions still did not have an official business purpose as they appeared unreasonable or personal in nature.

Among the KEMI expenditures that appeared unreasonable or more personal in nature, a number of meal and gift expenses were identified. For example, included in a reimbursement request made by the KEMI Manager on October 20, 2016, were a lunch and a dinner on October 19, 2016, totaling $735. The first expense listed on this request was "for Lunch and day at Keeneland" with two investment consultants totaling $470. In addition to the KEMI Manager and the two consultants, the request identifies attendees included the KEMI Director of Underwriting, a KEMI staff member, and a KEMI Board member. While the request notes the attendees and a specific purpose of the expense, to discuss "regarding Investment Guidelines & possible CLO Investment alternatives," the supporting documentation provides no detail identifying what was included in the expense. Following that outing, the KEMI Manager and a KEMI Board member traveled downtown for a meal costing $260, including $108 in liquor and $97 for food to discuss "KEMI Modernization and Red Tape Initiative." Although business may have been discussed in both instances, the need for expending policyholder funds in this manner is questionable and appears to be used more for personal entertainment than serving an official business purpose.

In some instances, additional inquiry or research regarding the purpose of the expense or how an item was used or distributed only led to further concern regarding KEMI spending. For example, on April 11, 2017, the KEMI Manager submitted a Travel Expense Report for a trip to a Client Symposium in Florida. The supporting documentation identifies the KEMI Manager traveled the morning of April 5, 2017 through the evening of April 8, 2017. No agenda or other documents describing the symposium were included in the supporting documentation. Through research the agenda for this symposium was identified, see Appendix C: Symposium Agenda. As seen in Appendix C, the agenda for the three-day symposium consisted of approximately three hours of industry presentations. The remainder of the trip appears to consist of receptions, meals and entertainment, including several hours set aside for two golf outings. The agenda shows the final day of the symposium included nothing more than breakfast, four hours of golf, and lunch. According to the expense reimbursement, KEMI incurred at least $610 in association with this trip. Furthermore, while KEMI policy requires pre-approval for travel, the pre-approval submitted for this travel was dated and signed by the COO on April 27, 2017, weeks after the Manager returned from the trip on April 7, 2017. For policies and controls to be effective, management must lead by example and follow the policies just as required for all other agency personnel.

Additionally, KEMI does not maintain or document the attendance of all events. Of the 172 expenditures examined which lacked adequate supporting documentation, KEMI did not document the ticket usage or the individuals attending or participating in the events of 99 advertising, marketing, and sponsorship related expenses. KEMI provided six spreadsheets used to track the ticket usage for the University of Kentucky and University of Louisville basketball and football season tickets, as well as other sports-related events, Louisville City Football Club season tickets, attendees of the How KEMI Sees Comp event at Keeneland, and the Agent Event at Rupp Arena. However, as will be discussed later in Finding 10 (page 52), the spreadsheets lack detail of the ticket usage.

No Policy for Reimbursement Beyond Travel Policy

KEMI HR Policies outline the agency's employment policies and practices; however, the policies do not specifically address employee reimbursements beyond business travel and mobile device data expense related reimbursements. Of the 107 individual KEMI reimbursements reviewed, 85 were for other expenses when an employee is not in travel status. The reimbursements were for local meals for employees and local meals for guests of employees with some meals including alcohol; employee celebrations of holidays, work achievements, and recognition; retirement gifts, sporting event tickets, golf outings, sponsorships, and other items such as a refrigerator and car washes.

When asked what policy exists for employee reimbursements that are not travel related, the KEMI CFO stated, "In the event that an employee needs to be reimbursed for an expense that does not fall under the category of a Travel expense, a Miscellaneous Expense Reimbursement Form would be the documentation that should be completed." The Miscellaneous Expense

Reimbursement Form is a standalone form requiring the purchaser to identify their name, title, identification of the item purchased along with amount of the request. The form includes a statement that the employee recognizes the purchases for which they are seeking reimbursement are "exempt from sales tax," necessary in the performance of the employee's duties, and were made in accordance with KEMI's procurement policy. The form indicates a requirement for itemized receipts to support the purchase, but provides no further guidance on what is and is not allowed for reimbursement outside of general procurement policies and the travel policy.

Written guidance helps to control spending and establish parameters by which spending may occur. While some non-travel related meals may serve a business purpose, other meals, such as an appreciation luncheon for the Activities Committee, a volunteer committee of employees responsible for planning employee appreciation events held throughout the year, such as the Easter Party, Movie Day and other events, appears to serve no business purpose. KEMI policy does not address when it is appropriate for KEMI to incur expenses such as a local meal on behalf of a vendor, a business partner, or employees. No policy exists to define when it is appropriate to purchase alcohol or provide entertainment. Additionally, although evidence of retirement gifts and retirement parties was identified in testing, KEMI has no policy for such expenses.

Employee Gifts and Celebrations

Review of KEMI expenditures and expense reimbursements identified instances of purchases for gifts to employees for bereavement, holidays, retirements, and other celebrations. KEMI budgets funds for "employee relations" each year. In 2018 the KEMI budget for employee relations was $88,420; the amount budgeted for employee relations was $144,500 in 2016 and $72,300 in 2017. As discussed in Finding 7 (page 41), expenses for such activity are not consistently coded to the appropriate budget code. In some instances celebratory expenses were coded to advertising and meals relating to travel.

In discussing expenses associated with retirements, KEMI personnel explained the agency typically budgets and pays for food at all retirement parties held in the office; however, gifts are not typically purchased with KEMI funds. Instead those are normally bought through contributions from staff. In 2016, KEMI allowed an exception to this rule due to five employees retiring around the same time that year, explaining "it would have been hard on employees to contribute to so many at one time." Testing a sample of expense reimbursements identified retirement gifts for two retirees, each costing approximately $250 per retirement gift. This may be a kind gesture by KEMI to take the cost burden away from its employees due to a number of retirements, but spending for parties and gifts is personal use of policyholder funds. KEMI should scrutinize these type of expenses and ensure that all spending supports KEMI business purposes.

Gratuity Percentages Exceeded 20%

Testing identified instances of gratuity provided at restaurant meals that exceeded 20%. KEMI has not established a policy restriction on the amount of gratuity that may be reimbursed or paid with KEMI funds. Kentucky Administrative Regulation, 200 KAR 2:006, allows reimbursement of gratuity to state personnel who are eligible to receive reimbursement for actual meal expenses if the gratuity amount does not exceed 20% of the meal cost. Although KEMI is not a state agency required to follow Kentucky Administrative Regulations, this regulation provides reasonable guidance that KEMI can use. Of 107 expense reimbursement transactions tested, 43 included meals with gratuity. Of those meals with a gratuity, eleven instances were identified when gratuity paid exceeded 20%.

In one instance the excess gratuity appears to be the result of a decentralized procurement process. Each spring, KEMI hosts an agent event, How KEMI Sees Comp, at Keeneland to provide agents updates on KEMI business, along with a guest speaker to present various topics. On April 27, 2017, the Manager submitted a reimbursement request for a bar tab of $589.36 along with a tip of $1,030.64 associated with this agent event. The bar tab had been an additional expense incurred the day of the event. Expenditure records show KEMI previously paid $4,734.84 for the event food, beverage, and AV Equipment on March 24, 2017, including a 22% service charge. By tipping this amount, KEMI in essence tipped Keeneland personnel a total of 42.15% of the total bill. The Manager was not aware that a service charge had been previously paid, noting that he would have asked about that and was misinformed.

Recommendations

We recommend KEMI require employees provide sufficient documentation to properly support expenditures, including the purpose of the expense, how the items purchased are intended to be used or distributed by KEMI, and detailed description of the item purchased. We recommend KEMI staff not process for payment any request containing an insufficient level of detail.

We recommend the KEMI Board develop policies to provide specific parameters for allowable meal and entertainment expenses when not in travel status, gratuities, alcohol purchases, as well as, retirement gifts and parties. The policies should apply to all KEMI employees, including executive management and board members. Once a policy is established, the policy should be distributed to all KEMI employees, and management should ensure the policy is administered as intended.

We recommend the KEMI Board review in detail the agency's spending on employee relations to ensure the activity level is prudent and in the best interest of its operations and policyholders.

Report continues with Finding 9 on next page.

<u>Finding 9: KEMI's Record Retention Schedule is Not Followed Consistently, Which Led to Lack of Important Records during the Examination</u>

KEMI faces several issues concerning its internally created records retention schedule. First, KEMI staff are not consistently following the retention schedule, as evidenced by the inability to provide certain documents requested during the examination. Second, certain sections of KEMI's retention schedules, particularly the period to maintain procurement supporting documentation, are less stringent in comparison to the general records retention schedule established for state agencies. Third, the Board did not approve the initial records retention schedule nor any of the 22 revisions made to that schedule during the examination period.

During the course of the examination, auditors encountered two situations in which KEMI had not followed the requirements listed in their Record Retention Schedule. The first situation involved personnel records and the second involved procurement records.

Performance Appraisals for All Positions at Director Level and Above Prematurely Destroyed

KEMI's employee personnel files are disposed of six years after the employee is no longer active with the organization. Employee personnel files include documents related to the hiring process, promotions, performance evaluations, confidential pre-employment results and EIP documentation. These confidential records document an individual's performance and employment history with KEMI. While examining documentation to support promotions and EIP payments during the examination period, auditors noted that annual performance appraisals, which factor into EIP payments to eligible employees, had not been maintained for those staff at the Director and above level who had been assigned key strategic initiatives for their areas.

KEMI's HR Director stated that the 2016 individual performance appraisals for all Directors and above had already been destroyed. This was an informal practice adopted by the former HR Director for HR staff to dispose of the prior year's individual EIP documentation once the current-year EIPs had been received. In response to initial inquiries, KEMI HR was able to recreate the appraisals of all but two employees by requesting those employees affected re-submit their appraisals. Those two employees were no longer employed by KEMI, but had been employed there less than six years ago. Re-creation of documents can lead to inaccuracy and skew results. In this case, evaluations were created by the employee as a self-evaluation and approved by their supervisor. There was no way to verify that the re-created documents were the same ones originally submitted and approved. Consistently following and maintaining record retention policies helps ensure valuable information is preserved and available.

Supporting Documentation for Procurements Not Provided

KEMI's Procurement Policy indicates the process to procure by competitive negotiations requires KEMI to (1) issue a Request for Proposal (RFP); (2) publish notice of the RFP in the media at least seven days prior to the date and time for the opening; (3) open proposals publicly as stated in the RFP; (4) accept all proposals without any alterations or corrections, except as authorized by the policy; (5) evaluate proposals based upon requirements, terms, conditions and specifications in the RFP; (6) document the general substance and date of any oral discussions; and (7) award a contract in writing to the responsive and responsible offeror whose proposal offers the best value to KEMI.

KEMI's Records Retention Policy regarding procurement supporting documentation is set for one year after the purpose for which it was created is complete or provides value. Therefore, once awarded, all procurement supporting documents including advertisements, tally sheets, letters, and responses to RFPs, are maintained for one year before being disposed of along with all the proposals received, except for the winning proposal, which is maintained with the RFP, award letter, and any resulting contract.

Auditors examined 26 contracts, reviewing supporting documentation required by KEMI policy based on the specific procurement method and process used. While supporting documentation for RFPs issued in 2017 was scheduled to be disposed of in 2018, KEMI's Director of Internal Auditor stated that all supporting documentation related to RFPs from 2017 to present was available to review because KEMI had not disposed of any RFP related information that year due to the APA's pending examination.

Despite the procurement documentation requirements pertaining to competitive negotiations and the statement by KEMI's Director of Internal Auditor, auditors observed that several supporting documents required for certain procurements were missing. Therefore, auditors were unable to clearly determine if contract services were procured in accordance with policies or whether the documents had been destroyed, misfiled, or had not previously existed. Specifically, auditors determined that KEMI had not maintained or was unable to provide complete procurement supporting documentation for the following seven contracts.

- Documentation of date and general substance of any oral discussions was not maintained or provided for three contracts issued in late 2017 (Kenning Consulting, Inc., EOP Architects, PSC, and Conning Inc.).
- Contract files for Dean Dorton Allen Ford, PLLC and Towers Watson, Inc. lacked several supporting documents, as both files included only the RFP and Award Letter as supporting documentation.
- KEMI provided no procurement documentation other than the RFP to support the contract with Oliver Wyman Actuarial Consulting, Inc.
- KEMI did not maintain or provide any procurement supporting documentation for the 2017 contract with Deutsche Investment Management Americas Inc., but did provide auditors with documentation to support a contract with the same vendor entered into several years prior to the examination period.

Comparison of KEMI Retention Periods to State Retention Periods

The Records Retention Schedule used by KEMI is organized similarly to the state's schedule, but with different time frames for certain documents. Some of these are compared in Figure 7 (below).

Figure 7: Comparison of Selected KEMI Record Retention Periods to General State Agency Retention Periods

Types of Record	State Agency Retention Period	KEMI's Retention Period
Contracts, Leases, & Agreements	8 years after completion, termination, expiration, or audit, whichever is longest	Dated before July 15, 2014 – 15 years after purpose for which it was created is complete or provides value. Dated after July 15, 2014- 10 years after purpose for which it was created is complete or provides value. Regardless of the date, only the response from the winning bidder is maintained.
Procurement Supporting Documentation/Records	8 years after expiration of authority to purchase, date of transaction termination or award of contract, whichever is longest	1 year after purpose for which it was created is complete or provides value
A/P Records	8 years after payment, termination of contract, end of project or liability, or after audit, whichever is longest	6 years after purpose for which it was created is complete or provides value.
Minutes of Meeting	Retain permanently	Retain permanently
Personnel File	5 years if employee's master personnel file is maintained by a separate agency; if employee transfers to a new agency the file will transfer with them; retain 50 years after date of separation if employee's master file is not maintained by a separate agency	6 years after employee is no longer employed by KEMI.
Annual Employee Performance Evaluation	Supervisor maintains the evaluation file for the current year until the final evaluation is complete. When the evaluation is complete, the evaluation and any supporting documents are transferred to the employee's agency personnel file (See previous entry for ***Personnel File***.)	6 years after employee is no longer employed by KEMI. Note: The Annual Employee Performance Evaluation and individual EIP documentation are included in the employee's Personnel File. (See previous entry for ***Personnel File***.)

Source: APA based on KEMI policies and the General Schedule for State Agencies 12/08/2011

One example of a significant difference between the two schedules involves supporting documentation for procurements. This type of document includes, but is not limited to, records such as advertisements, tally sheets, letters, responses to RFPs and competitive sealed bids by losing bidders. However, as KEMI's retention schedule now reads, these documents could be disposed of prior to completion or termination of the related contract. At KEMI, such documents are disposed of only one year after the purpose for which it was completed has ended or value has been provided, while the state suggests an eight-year retention period, which starts after expiration of the authority to purchase, date of transaction termination, or date of award of contract occurs, whichever is longest.

A second example involves contracts, leases, and agreements. Although KEMI's Records Retention Schedule requires that such records be maintained longer than the period suggested in the General Schedule for State Agencies, losing responses to RFPs are specifically omitted from the list of applicable documents. As a result, only responses from the winning bidder are maintained for this period.

In both cases, such documentation serves an important role, as it documents the procurement process and supports the specific procurement method used in contracts, leases, and agreements. These documents provide support for legal contracts and ensure proper policies were followed for auditing purposes. For example, according to KRS 413.160, contracts executed after July 15, 2014 have a ten-year statute of limitation. Therefore, these documents have legal relevance well past one year and should be maintained and accessible in the event of future litigation.

Numerous Revisions to Retention Schedules Occurred Without Notice to the Board

KEMI's Record and Information Management (RIM) Policy is a general policy included in a set of policies known collectively as the HR Policies. The RIM policy "pertains to the maintenance of information throughout its life cycle of creation, active use, inactive storage and disposition." This policy states, in part, that "[r]ecords are to be retained and destroyed in accordance with the Records Retention Schedule." This policy does not identify KEMI record types or suggest appropriate retention periods for each record type, but it was approved by the Board, both initially and as any subsequent revisions were made.

In contrast, a Records Retention Schedule is a list of each type of record maintained by an entity with descriptions of each record, the retention period, and disposition instructions. KEMI has maintained a log that documents all additions, changes, and deletions made to their Records Retention Schedule since its inception. The log lists all edits by type, followed by section within the schedule. Additions, deletions, and revisions to the Records Retention Schedule required the Legal Unit to conduct a statutory and regulatory review, but did not require Board approval. KEMI frequently edited their Records Retention Schedule during the period examined. Some edits added or deleted sections, while others changed definitions, titles, and the length of time required for retention. From January 1, 2016 to April 30, 2018, KEMI made 22 revisions to their Retention Schedule document, which included 14 additions, 57 changes, and 37 deletions (108 individual edits in total). While the requirement for Board approval of revisions to the Records Retention

Schedule is not specified in the RIM Policy, requiring such approval might decrease the frequency with which revisions are made and make the process more transparent.

Recommendations

KEMI should consider adopting a Records Retention Schedule with timeframes similar to those used by other state agencies. This would ensure a sufficient retention period for contracts and employee personnel files, as well as other documentation for auditing and administrative purposes.

In addition, KEMI staff should be trained and reminded of the importance of adherence to retention periods concerning all documents, as this woul44d eliminate the need for document re-creation, or loss of evidence that may be required for historical perspective or litigation.

The Board should consider whether to require Board approval of revisions to the Records Retention Schedule. If it is determined that such approval is desired, the Board should document the approval process for revisions to the Records Retention Schedule in the RIM policy.

Report continues with Finding 10 on next page.

Finding 10: Advertising Activity is Extensive and at Times Appeared Unfocused with Limited Accountability

KEMI advertising involves a wide range of activity including, but not limited to, donations to local civic and charitable organizations, sponsorship and participation in golf tournaments, sponsorship of college sports programs, and sponsorship of legislative events. KEMI does not believe their procurement policy governs such expenditures. While KEMI revised its Procurement Policy, effective January 1, 2019, addressing marketing and advertising related expenditures, the two policies in effect during the period examined indicate the policy applies to all procurement of goods and services, and did not provide an exception for advertisements, marketing, or sponsorships. As a result, from the sample of 26 contracts reviewed, KEMI did not accurately procure four advertising, marketing, or sponsorship related contracts during the period examined. The procurement of marketing and advertising related expenditures should be treated as a Sole Source Procurement; however, no documentation existed to justify the vendor selected. Furthermore, KEMI did not adequately use benefits derived from sponsorships toward achieving marketing goals or consistently track the use of these benefits calling into question the need for such expenditures.

KEMI's marketing and communication plan is internally developed and presented to the Board each year for approval as part of its overall Strategic Plan. The marketing and communications plan provides a generalized market strategy targeting "agents, policyholders, employers at-large, injured workers, medical providers, business partners and KEMI employees." Details of the exact sponsorships or advertisements are generally not identified in the marketing and communication plan. While details of intended sponsorships are available to the Board as part of the annual budget process, details associated with the actual advertising are not typically discussed further with the Board.

Current Procurement Policy Does Not Apply to Advertising/Sponsorships

Four advertising, marketing, or sponsorship related contracts were not accurately procured due to no quote or written determination being documented. Based on the procurement policy in effect at the time, KEMI selection would have been considered a sole source procurement. In a sole source procurement, the Manager or his designee "shall make a written determination" to allow the procurement to proceed. KEMI does not believe their procurement policy governs such expenditures. In October 2018, the KEMI Board approved a revised Procurement Policy, which specifically excluded advertising, memberships, sponsorships, employment matters and other various services.

For years 2016 through 2018, KEMI budgeted a total of over $1,753,000 for advertising expenses. The following issues were identified after reviewing a sample of 342 KEMI expenditures and 107 expense reimbursements incurred from January 1, 2016 through April 30, 2018:

- Thirty-four advertising related expenditures were not procured consistent with KEMI's procurement policy.

- Seven expenditures included additional costs for team registration or team fees beyond the costs of a golf-hole sponsorship with no additional explanation. In some instances sponsorship opportunities include an allowance for a player or team of players to participate, but in these instances KEMI incurred additional costs for participants separate from the actual sponsorship. For example, on February 23, 2017, KEMI paid $3,750 for a hole sponsorship and for a team of four players to participate in the Kentucky Chamber 2017 Golf Invitational at Valhalla Golf Club. The actual sponsorship cost $995, but KEMI elected to also incur the expense for a foursome to participate in the tournament. The supporting documentation for this payment only consisted of an invoice, no additional details were provided. KEMI participated in the 2016 invitational as well, incurring a similar expense, with the same level of information documented to support the expense.
- A $250 expenditure in 2017 for a "Handicapping Seminar" presented by Tom Leach to agents and guests attending the How KEMI Sees Comp event held at Keeneland. Through the How KEMI Sees Comp event, KEMI offers agents company updates provided by KEMI representatives. KEMI staff initially described the expenditure as a "Speaker gift for participation in the How KEMI Sees Comp agent education and networking event." However, further inquiry confirmed Tom Leach spoke about handicapping horse racing at the agent event. The event location, meal, and beverages (including alcohol) cost approximately $9,000 each year in 2016 and 2017. Event attendees included the Manager's spouse in 2016.
- One hundred seventy-two of 449 expenses reviewed were not supported with appropriate detailed supporting documentation. This includes 96 advertising and sponsorship related expenses in which KEMI received a table, tickets, or registration. In these instances KEMI did not document the specific individuals attending or participating in events.

Use of Marketing Tools Not Consistently Tracked and Ineffective Oversight of Associated Spending

While KEMI acknowledged not tracking attendance to all events, some effort was made to track attendance to local college and professional sporting events and agent focused events, such as How KEMI Sees Comp. Review of KEMI's tracking worksheets identified these records as incomplete. Overall, detail of how tickets were used was not maintained as the name of each guest attending the games or events was not listed; instead, one individual's name is presented for all four guests attending. There were also instances when KEMI employees attended games or events with vendors, vendors were the sole attendees, and KEMI employees or Board members were the only guests attending the game or event. Instances in which spouses of KEMI employees attended events were also identified, as well as instances when KEMI identified the ticket "unused" and/or "undocumented." Tracking the use of benefits derived from sponsorships and advertising packages is necessary to not only hold agency personnel accountable but to ensure advertising opportunities are fully utilized to the benefit of the agency and its policyholders.

In discussing the use of season tickets to the University of Kentucky basketball games, the Manager acknowledged the tickets were not used for marketing purposes. The tickets were provided to KEMI as part of a sponsorship package. The Manager stated that he had used the tickets as his predecessor had, distributing the tickets to employees. Figure 8 (below) summarizes the distribution of these and other tickets held by KEMI during the period examined.

University of Kentucky basketball tickets purchased by KEMI were often not used for marketing purposes and were instead distributed to KEMI employees.

Report continues with Figure 8 on next page.

Figure 8: Summary of KEMI Event Ticket Distribution 2016 through 2018

Event	Individual Guest Ticket Usage					
	Unused/ Undocumented	**KEMI**	**Spouse of KEMI**	**Business**	**KEMI Board Member**	**Policyholder**
How KEMI Sees Comp	-	52	1	96	1	-
Louisville City Football Club Season Tickets	12	12	-	24	-	16
UK Basketball Season Tickets	-	84	3	32	12	17
UK Basketball Coach Calipari Call-In Shows	5	11	-	4	-	-
UK Basketball Group Events	-	35	27	80	-	-
UK Football Season Tickets	16	64	2	2	4	-
UK Football Coach Stoops Call-In Shows	-	5	1	6	-	-
UK Football Group Events	3	8	1	10	-	2
U of L Basketball Season Tickets	20	43	1	88	-	-
U of L Basketball Coach Pitino Call-In Shows	-	10	1	61	-	-
U of L Basketball Group Events	11	25	4	18	-	-
U of L Football Season Tickets	4	10	1	61	-	-
U of L Football Group Events	-	18	9	79	-	-
Totals	**71**	**373**	**55**	**525**	**17**	**35**

Source: APA, based on KEMI Business Development Sports Tracker worksheets for 2015-2016, 2016-2017, and 2017-2018.

As shown in Figure 8 (above), KEMI records show many of the tickets to events were often given to KEMI management personnel and occasionally to one KEMI Board member and policyholders.

Testing of expenditures also identified an instance in 2017 in which the KEMI Director of Communications sought reimbursement of $3,055 for the purchase of 4 season tickets to UK Football games. The reimbursement request for this expense stated the tickets were "to be used by KEMI for business development purposes." However, review of the 2017-2018 KEMI's Business Development Sports Tracker file, found each of these tickets were assigned to KEMI management with no indication of attendance by agents, employers, or policyholders, calling into question the true nature of this purchase. This same purchase had been made by KEMI in 2016 for the 2016-2017 UK football season and coded as a marketing expense; KEMI records indicate some tickets may have been distributed to business partners that year.

Need for A More Formal Planning and Approval Process

While donations and sponsorship expenses may serve as an official business purpose on an individual level, KEMI would benefit from truly analyzing its full advertising and marketing activity. Although KEMI indicated that members of the management team meet to discuss advertising opportunities as they arise and opportunities are considered in preparation of the budget for the next year, the Manager noted that it is difficult to assess the effectiveness of marketing activity as KEMI does not have the metrics it needs. The Manager indicated a desire to seek request for information (RFI) for services to address this area. As noted in Finding 7 (page 41), testing identified KEMI has coded some business development expenses to codes beyond advertising, including meals as well as seminars and conventions. Coding business development expenses in this manner further limits KEMI's ability to truly analyze the extent and effectiveness of its marketing and advertising expenses. This step should be taken to create correct data before engaging an outside consultant.

Limiting expenditures to only those necessary to achieve marketing goals and documenting the use of related benefits received from such activity is paramount to hold agency personnel responsible and provide accountability to policyholders and the community KEMI serves.

Recommendations

We recommend KEMI adequately track the distribution and use of tickets, tables, and registrations associated with all advertising, marketing, and sponsorship activity to ensure transparency and accountability in its operations.

We further recommend KEMI use all benefits derived from its spending on advertising, marketing, and sponsorship activity toward meeting its marketing and communication plan to ensure the most effective use of policyholder funds.

As recommended in Finding 7 (page 41), we again recommend KEMI ensure coding accurately portrays actual spending to ensure business development expenses are fully identified. This will assist KEMI in conducting a fuller analysis of its advertising, marketing, and sponsorship spending.

Finally, we recommend the KEMI Board and management discuss the current marketing and communications plan, as well as organizational resources available, to determine whether additional resources are necessary to more adequately develop and track its advertising, marketing, and sponsorship activities. All activities should directly aid KEMI's strategic plan.

APPENDICES

Appendix A: Loss Portfolio Transfer Agreements

Kentucky School Boards Insurance Trust (KSBIT)

On October 31, 2014, KEMI and the Commissioner of Insurance of the Commonwealth of Kentucky, Rehabilitator of the KSBIT Workers' Compensation Self Insurance Fund entered into a loss portfolio transfer agreement. The KSBIT Rehabilitator transferred approximately $35 million in workers' compensation claims liabilities for the period July 7, 1978 through June 30, 2013, to KEMI. In exchange for this transfer, KEMI received $35 million in cash and guaranteed receivables. The individual school boards were given the choice between two options. They could pay their entire assessment as a lump sum, or pay 25% in cash and finance the remainder in interest-free installments over a maximum period of 6 years. Additionally, the Kentucky Department of Education will withhold the unpaid portion of the assessments from appropriations otherwise due to the school boards from the Commonwealth of Kentucky, in the event of nonpayment. The liability for KSBIT unpaid claims was $29,112,034, and the balance of the receivable for retroactive reinsurance reserve was $8,736,249, as of December 31, 2017. On March 18 2019, KEMI announced the approval of a plan to return $4.77 million to the KSBIT as a result of controlling claims costs.

Kentucky Workers' Compensation Funding Commission (the Funding Commission)

On July 7, 2017, KEMI and the Funding Commission entered into a loss portfolio transfer agreement. Workers' compensation liabilities for claims incurred on or after December 12, 1996, which were filed on or before June 30, 2017 (known as the Kentucky Coal Workers' Pneumoconiosis Fund, or KCWPF), were transferred from the Funding Commission to KEMI, and totaled approximately $40 million. In exchange for these claim liabilities, KEMI received approximately $19.3 million in cash. In addition, the Funding Commission will impose assessments, due to KEMI within 50 days of each quarter. Until both the Funding Commission and KEMI agree that the liabilities are fully funded, the Funding Commission will continue to impose assessments. As of December 31, 2017, the liability for the KCWPF unpaid claims was $39,911,414 and the balance of the receivable for retroactive reinsurance assumed was $17,879,380.

Appendix B: Employee Salaries, Benefits, and Other Perquisites

Operating as a competitive corporation, KEMI has designed an appealing benefits package for their employees that includes fitness membership reimbursements, a financial wellness program, an identity theft protection program, and a generous employee incentive plan, in addition to an assortment of insurance and retirement plans. KEMI also budgets for employee perks such as holiday decorations and gifts, employee events, and flowers, food, and gifts for funerals, births, retirements, birthdays, and rewards for service and accomplishments. KEMI has been named as one of the best places to work in Kentucky multiple times and has an *average* tenure of all full-time equivalent employees of 10.7 years.

KEMI has been ranked by the Kentucky Society for Human Resource Management state council and the Kentucky Chamber of Commerce as one of the best places to work in Kentucky five times since the recognition program began in 2005. Selection is based on both an assessment of the company's employee policies and procedures and the results of an internal employee survey. During the examination period, KEMI received a ranking of #2 in 2016 among medium-sized companies (150-499 employees).

Low turnover results in lengthier terms of tenure by staff. A recent staffing analysis conducted by an outside consultant reiterated this point by highlighting the tenure of both KEMI management and staff. Five of the six company leaders (Manager, VP/COO, VP/CIO, VP/CFO, and HR Director) have tenures of 20 or more years, while the seven directors averaged a tenure of 15.8 years. The consultant discussed potential advantages and disadvantages of an entity having tenure lengths such as those at KEMI. While job expertise and industry knowledge/networks have considerable value, tenured employees may become complacent and allow processes and standards to become intuitive rather than documented.

Options for Salary Adjustments

According to KEMI's HR Policies, the types of salary adjustments include: merit, promotion, demotion, market adjustment, equity, or a combination of any of the above. In addition to those adjustments, KEMI staff can also earn bonuses and annual EIP awards based on involvement in major initiatives/projects, positive performance appraisals, or achievement of key business objectives.

Bonuses

While the decision to award a bonus is not made in a vacuum, the Manager does have complete discretion in awarding them. Bonuses are project-based and amounts must remain within the approved budget. These are one-time payments that do not affect the base salary of the employee moving forward into the next year. In 2016, KEMI paid five employees a total of $8,000 in bonuses for their work on the retirement project. These employees included two VPs, one manager, and two staff members. The employees worked on various projects including, but not limited to, the claims settlement project, actuary review project, medical bill cost saving initiative, and dayforce implementation project.

Section 3 of the Kentucky Constitution prohibits the payment of bonuses to public employees for the performance of their duties; however the applicability of this restriction to employees of KEMI, a quasi-governmental entity, remains unclear.

Employee Incentive Plan (EIP) Awards

Guidelines for the EIP are updated annually by KEMI staff with the Manager being accountable for the oversight of the administration of the EIP. The process for awarding EIP payouts is dependent on the position held by an eligible employee. While EIP awards for staff below the Director level are based on job performance as evaluated in the salary merit review process, performance objectives and measures representing key outcomes supporting KEMI's annual Strategic Business Plan and budget achievement impact the level of EIP award that the Manager, Vice Presidents, and Directors are eligible to receive. Payouts in a given year represent performance and achievement in the preceding year.

According to KEMI's 2017 Budget, the EIP awards were budgeted at $1,400,000. However, this benefit is combined with the salaries expense for a total amount of $16,868,742, where $16,761,241 was actually expensed. KEMI contributed a majority of this variance to the attrition of staff in Claims, Underwriting, Systems, Application Development and open Call Director positions. KEMI noted that the favorable variance was offset by the payout for EIP awards being higher than anticipated in that year.

According to KEMI's 2018 Budget, EIP awards were allocated a budget of $1,600,000. However, this benefit is combined with the salaries expense for a total amount of $18,520,536. Thus far, as of March 31, 2018, $4,995,017 has been expensed.

This benefit is currently on hold and no EIP payments will be disbursed in 2019.

Employee Benefits

KEMI currently provides all full-time employees with ten employer paid (or partially paid) benefits, but offered three additional benefits during the exam period. These employer paid (or partially paid) benefits range from health insurance to fitness membership reimbursements and are listed below, along with projected costs for 2018 and an abbreviated description of each benefit based on KEMI records.

Employer-Paid (or Partially Paid) Benefits:

- **Health Insurance**- KEMI pays a portion of premiums for health insurance. Employees covered by another group sponsored health plan can waive KEMI health plan coverage and receive $200 per month.
- **Wellness Program**- Humana Go365 is a voluntary tiered wellness program that rewards employees based on their participation in a variety of health screenings, fitness programs

and community events. KEMI is expected to pay \$4.02/month for 299 participants (191 employees & 108 spouses; dependent children are included at no cost).

- **Fitness Membership**- KEMI reimburses employees up to \$25/month for a single gym membership if they achieve Humana Go365 Silver Status. KEMI is expected to pay \$25/month toward membership at year-end to 47 employees.
- **Financial Wellness Program**- The Dave Ramsey Smart Dollar financial wellness program educates employees and their household family members, at no cost, on savings, debt elimination, and retirement planning. KEMI paid a one-time fee for a year of access, averaging \$2.50/month/employee. **This benefit was discontinued in 2018.**
- **Employee Assistance Program**- This program helps employees and their household family members manage their daily lives and remain productive, even through difficult life experiences. KEMI is billed quarterly, averaging \$2.78/month/employee.
- **LifeLock-** LifeLock Benefit Elite program provided identity theft protection, stolen funds reimbursement and personal expense compensation to employees at no cost. KEMI paid \$6.99/month/employee for 204 participating employees. **This benefit was discontinued in 2018.**
- **Vision Insurance-** Single vision insurance is offered at no cost to employees. KEMI paid \$6.33/month/employee for 189 participating employees.
- **Employee Incentive Plan (EIP)-** EIP was an opportunity for employees to earn a percentage of their salary if objectives were met. As stated earlier in this appendix, **KEMI placed this benefit on hold in 2018, so no incentive pay will be disbursed in 2019.**
- **Retirement Plan**- Employees contribute a mandatory 6% of their salary to a Defined Benefit or 401(a) Money Purchase Plan. Employees may participate in a 457(b). In addition, employees that transferred from KRS to the KEMI Retirement Plan and were hired prior to 7/1/16 are eligible for a 50% match up to 3%.
- **Life and AD&D Insurance**- Life Insurance and Accidental Death & Dismemberment (AD&D) Insurance at two times' the employees annual salary (up to \$400,000 and Medical Underwriting may be required) is provided at no cost. KEMI pays \$0.19 per \$1,000 of benefit.
- **Short-Term Disability**- KEMI provides short-term disability benefits (60%) to employees until they earn 5 years of service. KEMI pays \$0.36 per \$10 of benefit.
- **Long-Term Disability**- KEMI provides long-term disability benefits (60%) to employees that begin at the 6th month of disability if they meet either an own occupation or an earnings test. KEMI pays \$0.45 per \$100 of covered payroll.
- **Parking**- Employees receive a parking pass for the Lexington office. KEMI pays \$85/parking pass per month (for 171 employees) & \$105/parking pass per month (for 10 employees).

KEMI also offered their employees eight voluntary employee paid benefits during the exam period. One of these voluntary benefits (LifeLock) was expanded to include employees after KEMI discontinued paying the employee portion for them. A list of all current employee paid voluntary benefits follows.

Employee-Paid Voluntary Benefits:

- **Vision Insurance**- Voluntary vision insurance for dependents.
- **Dental Insurance**- Voluntary dental insurance for themselves &/or dependents.
- **Health Care Flexible Spending**- Employee health care spending accounts are available with a $2,600 limit.
- **Dependent Care Flexible Spending**- Dependent care spending accounts are available with a $5,000 limit.
- **Voluntary Life, Voluntary Life & AD&D, Spouse Life and Child Life Insurance**- Employees may purchase additional life insurance coverage for themselves, spouse, &/or dependent children.
- **Accident Insurance**- Employees may purchase coverage for themselves, spouse, &/or dependent children.
- **Critical Illness Insurance**- Employees may purchase coverage for themselves, spouse, &/or dependent children.
- **LifeLock**- KEMI employees can add spouses and dependents up to age 26 to their own plans. **This benefit was changed in 2018 making it available for employees to purchase at a discounted voluntary rate for themselves and dependents.**

According to KEMI's budgets throughout the exam period, Employee Benefits include health insurance & waivers, 401(a) retirement plan contributions, 457 matching funds, and group life & disability insurances. KEMI's 2017 Budget allocated funds of $4,729,785 to the Employee Benefits account, while expensing $5,095,368 for the year. In a budget variance report for December 31, 2017, KEMI contributed this variance to "retiree health plan contributions of $312,000 which were not budgeted in 2017. In addition, 401(a) contributions were over budget by $326,272 because the employer match to the defined benefit pension plan was budgeted at 10% but paid at 15%. Also, dental and vision insurance were $21,595 over budget. Matching funds for the 457(b) plan were $38,422 under budget, and health insurance and waivers were $261,800 under budget, thereby offsetting much of this unfavorable variance."

According to KEMI's Employee Health & Benefit Survey conducted in 2017, the organization's employees value health insurance, retirement benefits, and dental insurance the most.

Employee Relations

In addition to these defined benefit programs, KEMI staff also receive other benefits and perks not listed in their HR Policies. This includes benefits such as, but not limited to, holiday gifts, birthday cards, service awards, bereavement gifts, employee appreciation events (movie day/lunches), and holiday events for staff and their families. KEMI has an Activities Committee, comprised of KEMI employee volunteers, which develops an events calendar and budget each year for employee relations. Executive management reviews, provides feedback, and approves the plan. Funding for employee relations is established in the budget, specifically under the HR Department's cost center. The Board approves this spending when it approves the budget each year.

Budget workpapers identify that Employee Relations account budgeting includes: fitness reimbursement, financial wellness program, LifeLock, holiday gifts, service awards, KEMI star/employee appreciation, potlucks & holidays, health fair, flowers for employee/administration condolences, employee appreciation (movie day/lunch), various lunches (visitors/staff/volunteers), management outings/luncheons, Easter egg hunt, holiday decorations, and welcome/birthday cards & baby gifts. Although the Employee Relations account includes sub-accounts like fitness reimbursement, financial wellness program and LifeLock that are technically employee benefits, the Employee Benefits account and Employee Relations account are closely related, as they are coded to the same category of accounts.

According to KEMI's 2017 Budget, funds of $72,300 were allocated to the Employee Relations account, while $62,055 was expensed for the year. The following table shows both the type of expenditures budgeted under Employee Relations and the amounts budgeted during the exam period. This is not an all-inclusive list of expenditures.

Sub-Accounts in b Account #709007: Employee Relations

Description	2016 Budget	2017 Budget	2018 Budget
Fitness Reimbursement*	20,000	20,000	20,000
Identity Theft Protection for Employees*	-	-	17,220
Holiday Gift	12,000	12,000	12,000
Financial Wellness Program*	4,000	-	6,500
Service Awards	7,000	5,000	5,000
Employee Appreciation/Employee Outing	15,000	2,500	5,000
KEMI Star/EE Apprec/Vend/Game Wk	5,000	5,000	5,000
Potlucks and Holidays	2,000	4,000	5,000
Various lunches – visitors/staff/volunteers	2,000	2,000	3,000
Flowers for EE's, admin and condolences	3,000	2,500	2,500
Easter Egg Hunt	1,000	1,500	2,000
Management Outings/Luncheons	4,000	2,000	2,000
Onboarding/Bday Cards/Baby Gifts	1,000	800	1,200
Holiday Decorations	1,000	1,000	1,000
Health Fair	3,000	3,000	1,000

*Sub-Account linked directly to an employee benefit, as listed in KEMI's HR Policies.
Source: Auditor of Public Accounts, based on budget information provided by KEMI

Budgeting and Coding of Other Employee Benefit Expenditures

As discussed in Finding 7 (page 41), not all employee benefits are coded under Employee Benefits or Employee Relations in the budget. The employee parking expenditure is included under the Rent expense category and was budgeted at $192,840, $208,800, and $196,740 for 2016, 2017 and 2018, respectively. Also, the EIP benefit appears as a salary expense and was budgeted at $1,470,000, $1,400,000, and $1,600,000 for 2016, 2017 and 2018, respectively.

Appendix C: Symposium Agenda

JLT Re

JLT RE SPRING SYMPOSIUM 2017
Agenda

Date / Time	Function	Location
Wednesday, April 5th		
Noon – 5:00 pm	Registration	West Lobby
6:00 pm – 7:00 pm	Welcome Reception	Great Lounge
7:00 pm – 9:00 pm	Buffet Dinner	Terrace A & B
Thursday, April 6th		
7:00 am – 8:45 am	Breakfast	Ballroom II
9:00 am – 10:00 am	**Rich Karlgaard** Publisher, Editor-at-Large and Global Futurist, Forbes, Economic Leader, Entrepreneur & Author. The author of the biweekly Forbes column, "Innovation Rules" and a respected forecaster, Rich will provide his views on the business and political trends he anticipates on the horizon.	Ballroom I
10:15 am – 11:15 am	**Steve Webersen** Managing Director and Head of Insurance Research at Conning & Co. "Outlook and Trends in the Property-Casualty Industry"	Ballroom I
11:15 am – Noon	**David Flandro**, JLT Re Global Head of Analytics **Micah Woolstenhulme**, JLT Re Head of Risk and Economic Advisory "Partnering with JLT Re in Economic Capital Modeling"	Ballroom I
Noon – 12:45 pm	Lunch	Ballroom II

JLT Re

Thursday, April 6th continued		
12:45 pm	Golf * *For those individuals that do not wish to play golf, you may enjoy time at the pool/beach and have access to the spa.*	Ocean Course
6:00 pm – 7:00 pm	Reception	Great Lounge/History Hall
7:00 pm – 9:00 pm	Dinner	Terrace A & B
Friday, April 7th		
6:30 am – 8:15 am	Breakfast	Terrace A & B
8:30 am – 12:30 pm	Golf	Lagoon Course
Noon – 1:30 pm	Lunch	Terrace A & B

Source: JLT RE Spring Symposium 2017 Agenda

Appendix D: Expanded Timeline of KEMI Real Property Procurement

Date	Document Name/Event	Details
8/26/2014	Audit/Finance/Investment Committee Meeting Minutes	KEMI management proposes revisions to the Investment Policy to the Audit/ Finance/Investment Committee to reflect investments in Real Estate Other Than for Occupation are prohibited without the expressed consent of the Committee. Motion is made and unanimously approved to adopt revisions and additions to the KEMI Investment Policy as presented and discussed by KEMI management and for the Committee to make a motion to the full Board to adopt the revisions and additions as presented and discussed and authorize KEMI Management to take the appropriate steps to implement the changes to the Investment Policy.
8/26/2014	Board Meeting Minutes	Based on discussion of the Audit/Finance/Investment Committe, proposed Investment Policy language is clarified to specify the real estate investment must be real estate for occupation. The Board approves and adopts the revisions and additions to the Investment Policy as presented and discussed by the Audit/Finance/Investment Committee as well as authorize KEMI Management to take the appropriate steps to make the revisions and implement the revised Investment Policy.
2/20/2015	**Mangold Real Estate Procurement Determination**	**KEMI Manager signs to approve the Barry Mangold, Mangold Real Estate Procurement Determination.**
2/20/2015	**Mangold Real Estate Confidentiality Nondisclosure Agreement**	**A Confidentiality and Non-Disclosure Agreement is entered into between KEMI, and Barry Mangold, individually, and Mangold Real Estate.**
3/1/2015	**Mangold Real Estate Consulting Agreement**	**KEMI Manager enters into a Real Estate Consulting Agreement with Barry Mangold, individually, and Mangold Real Estate. Agreement details the services Mangold is to provide KEMI and states Mangold will receive "fees in the amount of $10,000" as compensation for the services.**
12/22/2015	**Barry Mangold Payment**	**KEMI pays Barry Mangold $10,000 for Real Estate and Consulting Services per the Agreement dated March 1, 2015. Invoice for services is dated December 21, 2015 and include Site Evaluation, Mapping, Analysis, and Selection of potential office building locations. KEMI Manager approves invoice for payment on December 22, 2015.**
2/9/2016	Audit/Finance/Investment Committee Meeting Minutes	The Audit/Finance/Investment Committee authorizes the Manager to enter into a Real Estate Purchase Agreement for the purchase of approximately 21 acres of real property identified as lots 22 and 23 in the Kingston Hall, Providence Business Center Development in Fayette County, Kentucky. Purchase is subject to the conditions to closing contained in the Real Estate Purchase Agreement having been met and subject to the conditions an limitations contained in the KEMI Investment Guidelines. No discussion among Committee Members documented in the Committee Meeting Minutes. The Committee Members present include Mark Workman (Committee Chair), Sam Newcomb, Marvin Russow, and Ryan Barrow (Proxy for Sec. Landrum).
2/9/2016	Board Meeting Minutes	Audit/Finance/Investment Committee Chair, reports to the Board that the Committee met prior to the Board Meeting and took two actions in accordance with the Investment Policy. Specifically, relating to the procurement of land, the Chair reports the Committee authorized the KEMI Manager to enter into a real estate purchase agreement for "the purpose of conducting due diligence as part of considerations for building a building on the property." There is no discussion or vote documented in the Board Meeting Minutes. The Board Members present include Rita Phillips, Mark Workman, Sam Newcomb, Debra Nicholson, Marvin Russow, Ryan Barrow (Proxy for Sec. Landrum), Sec. Tom Stephens, and Sec. Derrick Ramsey.

Date	Document Name/Event	Details
3/4/2016	**Real Estate Purchase Agreement**	**The Real Estate Purchase Agreement is made and entered into between KEMI and Anderson Ramsey LLC. Total purchase price for the Property is $4,882,500 less the earnest money deposit of $250,000 with Rose Camenisch Mains PLLC upon the execution of the Agreement, plus or minus the proration of the items specified in Section 10 of the Agreement.** (Section 10 addresses real estate ad valorem taxes and assessments attributable to the Property which is to be prorated between the parties. It also states all exaction fees are the responsibility of the Buyer.) **Section 11 of the agreement addresses the brokerage commission and states that the seller shall be responsible for paying all customary and reasonable fees and commissions owed to the broker.**
3/4/2016	**Rose Grasch Camenisch Mains Escrow**	**KEMI pays Rose Camenisch Mains Escrow $250,000 for the deposit on the Real Estate Purchase.**
3/22/2016	Rose Camenisch Mains - Engagement Agreement	Former Vice President-General Counsel accepts and agrees to the Engagement of Rose Camenisch Mains, PLLC regarding representation in connection with the purchase of real property in Fayette County.
3/24/2016	Rose Camenisch Mains Escrow	KEMI pays Rose Camenisch Mains $4,900 for services rendered in relation to the Property Transaction.
5/3/2016	**Barry Mangold Invoice and KEMI Check Request**	**KEMI SIU Director submits check request for a $15,000 payment to Barry Mangold in association with contract not yet signed. Invoice from Mangold dated 5/3/16. Check request approved by KEMI Manager.**
5/4/2016	**Barry Mangold Broker and Consulting Agreement**	**KEMI SIU Director signs Broker and Consulting Agreement between Barry Mangold and KEMI. Agreement states Mangold has acted as KEMI's broker and provided consulting services regarding the identification of real property in Central Kentucky meeting the criteria set forth by KEMI for construction of a future headquarters. The agreement notes that Mangold has negotiated with Anderson Ramsey LLC to pay Mangold 2.5% of the purchase price paid by KEMI for the Contracted Property. In addition, KEMI desires and agrees to compensate Mangold for the additional Services in an amount equal to 1% of the purchase price.**
5/4/2016	**Barry Mangold Payment**	**KEMI pays Barry Mangold $15,000 for Real Estate and Consulting Services.**
5/9/2016	S&ME Agreement	KEMI SIU Director signs agreement with S&ME for Geotechnical Services and Phase I Environmental Site Assessment (ESA) for the Kingston Hall Lot 22 in Lexington, KY.
5/12/2016	Rose Camenisch Mains Escrow	KEMI pays Rose Camenisch Mains $1,877.50 for services rendered in relation to the Property Transaction.
5/27/2016	**First Amendment to Real Estate Purchase Agreement**	**The First Amendment to Real Estate Purchase Agreement by and among KEMI, Anderson-Ramsey LLC, Lees2826 LLC, and Ramsey I-75 LLC, is dated effective as of May 27, 2016.** According to the amendment, Lees and Ramsey, along with Anderson, are owners of undivided interests in the Property subject to the Purchase Agreement. The amendment to the Purchase Agreement joins each Lees and Ramsey as a Seller as if each were an original signatory to the Purchase Agreement. Additionally, Section 7 – Closing of the Purchase Agreement was deleted entirely and replaced, and a new paragraph added to the end of Section 9 – Seller's Covenants. **Agreement specifically identifies that Seller will pay Barry Mangold a commission equal to 2.5% of the purchase price.**
6/2/2016	Rose Camenisch Mains Escrow	KEMI pays Rose Camenisch Mains $1,877.50 for services rendered in relation to the Property Transaction.
6/16/2016	S&ME Inc Payment	Following the completion of the Phase I Environmental Site Assessment at Kingston Hall – Lot 22, KEMI pays S&ME, Inc. a lump sum of $3,500.

Date	Document Name/Event	Details
7/21/2016	Rose Grasch Camenisch Mains Escrow Payment	KEMI pays Rose Grasch Camenisch Mains Escrow $4,545 for services rendered in relation to the Property Transaction
8/5/2016	S&ME Inc Payment	KEMI pays S&ME, Inc. the lump sum amount of $16,000 upon completing the Geotechnical Exploration Services at KEMI's Kington Hall.
8/18/2016	Rose Camenisch Mains Escrow	KEMI pays Rose Camenisch Mains $3,307 for services rendered in relation to the Property Transaction.
9/1/2016	Rose Camenisch Mains PLLC	KEMI pays Rose Camenish Mains $5,801 for services rendered in relation to the Property Transaction.
9/8/2016	Certificate (Anderson-Ramsey, LLC) - 09-08-2016	Dennis Anderson, Member of Anderson-Ramsey, LLC, signs the Certificate certifying he owns 62.95% of the membership interest in the Entity.
9/8/2016	Certificate (Lees2826, LLC)	Dennis Anderson, Member of Lees 2826 LLC, signs the Certificate certifying he is the sole member of the Entity.
9/8/2016	Ramsey I75 quitclaim deed	The Quitclaim Deed and Consideration Certificate was made and entered into by and between Ramsey I-75, LLC, and Anderson Ramsey, LLC.
9/8/2016	Lees2826 quitclaim deed	The Quitclaim Deed and Consideration Certificate is made and entered into by and between Lees2826, LLC, and Anderson Ramsey, LLC.
9/8/2016	Declaration of Common Area Maintenance Agreement Easement & Restrictions	The Declaration of Common Area Maintenance Agreement, Easements and Restrictions, Providence Place, Section 2 is made and entered into by Anderson-Ramsey LLC, Anderson Acquisitions LLC, Anderson Communities Inc., and Providence Business Center LLC.
9/8/2016	Certificate of NonForeign Status by Entity Transferor	Dennis Anderson, Member, signs the Certificate of Non-Foreign Status by Entity Transferor certifying Anderson-Ramsey, LLC is not a foreign corporation, foreign partnership, foreign trust or foreign estate.
9/8/2016	Assignment of Real Estate Purchase Agreement (I75)	The Assignment of Real Estate Purchase Agreement by and between Ramsey I-75 LLC and Anderson-Ramsey LLC is made and effective on September 8, 2016.
9/8/2016	Assignment of Real Estate Purchase Agreement (Lees2826)	The Assignment of Real Estate Purchase Agreement by and between Lees2826 LLC and Anderson-Ramsey LLC is made and effective on September 8, 2016.
9/8/2016	Reaffirmation of Representations & Warranties	Dennis Anderson signs the Reaffirmation of Representations and Warranties Certificate.
9/8/2016	Substitutes From 1099-S (2016)	The Substitute Form 1099-S & Seller's Tax ID Certification signed by Dennis Anderson.
9/9/2016	Officer's Certificate of KEMI	KEMI Manager signs the Officer's Certificate of KEMI certifying to Anderson Ramsey LLC he is the duly appointed and acting President and Chief Executive Officer of KEMI. The Certificate also certifies that KEMI is a nonprofit, independent, self-supporting de jure municipal corporation and political subdivision of the Commonwealth of Kentucky created pursuant to KRS 342.803. Further, "Exhibit A is a true and complete copy of the motion and resolution duly adopted by the Audit-Finance-Investment Committee of KEMI authorizing the Purchase Agreement and purchase of the Property as contemplated thereby."
9/9/2016	Certificate (Ramsey I-75 LLC)	Frank Ramsey & William N. Ramsey, Jr., Members of Ramsey I-75 LLC, sign the Certificate certifying they are the only Members of the Entity.
9/9/2016	Deed of Conditional Easement to KEMI	The Deed of Conditional Easement by and among Anderson-Ramsey LLC, Anderson Acquisitions LLC, and KEMI, is made and entered into effective as of September 9, 2016.

Date	Document Name/Event	Details
9/9/2016	Deed of Permanent Easement to KEMI	The Deed of Permanent Easement by and among Anderson-Ramsey LLC, Anderson Acquisitions LLC, and KEMI, is made and entered into effective as of September 9, 2016.
9/9/2016	Escrow Agreement (Traditional Bank)	The Escrow Agreement entered into among Anderson Ramsey, LLC, KEMI, and Tranditional Bank, Inc. Section 6 of the Purchase Agreement requires an amount sufficient to construct the road and install the sidewalks, curbs, storm sewers, and sanitary sewers to the Property be deposited into an Escrow Account from the proceeds of the Purchase Price. At Closing, Anderson Ramsey, LLC, and KEMI have deposited an amount equal to $2,062,500.00 in Escrow Funds with Traditional Bank, Inc.
9/9/2016	Warranty Deed to KEMI from Anderson Ramsey I75	The Warranty Deed between KEMI and Anderson Ramsey, LLC, is made and entered into on September 9, 2016.
9/9/2016	Owner's Affidavit (Anderson Ramsey LLC)	Dennis Anderson, Anderson Ramsey, LLC signs the Owner's Affidavit.
9/9/2016	Settlement Statement (Final-Executed)	KEMI, Anderson-Ramsey LLC, and Rose Grasch Camenisch Mains PLLC sign the Settlement Statement.
9/9/2016	**Rose Grasch Camenisch Mains PLLC**	**KEMI initiates the $4,669,578.28 wire transfer to Rose Camenisch Mains Escrow for the purchase of land.**
9/15/2016	EA Partners Payment	KEMI initiates an $18,020.36 payment to EA Partners, PLC for services related to the Real Estate Property including the ALTA Survey, Final Development Plan, and Administration & Coordination.
11/3/2016	EOP Architects, PSC Payment	KEMI initiates a $1,200.00 payment to EOP Architects, PSC for the Providence Place Guideline Revisions incurred from September 1 to 30, 2016.
11/10/2016	Rose Camenisch Mains PLLC	KEMI pays Rose Camenisch Mains at least $16,366 for services rendered in relation to the Property Transaction.
12/22/2016	Rose Camenisch Mains PLLC	KEMI pays Rose Camenisch Mains $187.50 for services rendered in relation to the Property Transaction.
6/12/2017	The Allen Company Construction Contract	SIU Director authorizes the contract for the construction and services in connection with the Property Clearing Services between KEMI and The Allen Company, Inc.
6/29/2017	EOP Architects, PSC Payment	KEMI initiates an $8,400.00 payment to EOP Architects, PSC for the KEMI Program Document Update incurred from May 1 to 15, 2017.
11/16/2017	EOP 1738 KEMI Hdqtrs - Pre-Design Services Proposal	The EOP Architects Proposal includes a cost analysis proposal of the new headquarters to present to the Board as well as the Total Architectural Pre-Design Services Fee of $15,535.
11/30/2017	Rose Camenisch Mains PLLC	KEMI pays Rose Camenisch Mains $90 for services rendered in relation to the Property Transaction.
12/14/2017	EOP 1738 KEMI Hdqtrs - Concept Design Services Proposal	EOP Architects' Concept Design Proposal of the new headquarters outlines the concept level study for the new facility vision addressing spatial/functional needs and includes the proposed Total Architectural Pre-Design Services Fee of $118,950 (lump sum) and Professional Renderings of $8,000 (4 at $2,000 each).
1/18/2018	EOP Architects, PSC Payment	KEMI initiates a $13,500.00 payment to EOP Architects, PSC for the Pre-Design Services incurred from November 1 to December 31, 2017.
4/4/2018	KEMI Personal Service Contract, 18-EOP-001 submitted to GCRC	KEMI submits EOP Architects Personal Service Contract to the GCRC on April 4, 2018. The contract was effective November 1, 2017, through June 30, 2018 and is not to exceed $145,000.00 for the services performed, which include the pre-design architectural services to include a cost analysis of building ownership versus the lease in the existing facility, creation of a concept design addressing functional needs, site plan, schematic floor plan, and renderings for presentation to the KEMI Board. GCRC approves the Contract on May 8, 2018.

KEMI'S MANAGEMENT RESPONSE

KEMI
Kentucky Employers' Mutual Insurance

250 West Main Street, Suite 900 Lexington, KY 40507-1724 859-425-7800 www.kemi.com

April 12, 2019

Hon. Mike Harmon
Auditor of Public Accounts
Commonwealth of Kentucky
209 St. Clair Street
Frankfort, KY 40601

RE: Examination of Certain Policies, Procedures, Controls, and Financial Activities of the Kentucky Employers' Mutual Insurance Company (KEMI)

Dear Auditor Harmon:

On behalf of the KEMI management team and the Board of Directors (Board), we appreciate the work of your team in responding to the Board's request to produce a special audit of KEMI. Additionally, we appreciate the oversight role your office has provided to KEMI since our inception.

As you note in the audit, an examination of KEMI requires an understanding of its dual role of being a state-created entity and a competitive insurance company. KEMI is in a very unique position as it is required to operate under these oftentimes conflicting conditions. We understand that your review used criteria applicable to state agencies and not competitive insurance companies.

Recognizing the need for increased transparency, accountability, and adherence to its own procurement policy, KEMI and its Board proactively began working together to develop corrective actions to remedy deficiencies that were identified by the Board, management and our internal auditor. Prior to the issuance of your audit, KEMI and the Board have done the following:

- Defined expectations of the Manager of KEMI with regards to authority, communication and transparency.
- Worked with the Board and procurement experts within the Finance and Administration Cabinet to revise the procurement policy to ensure greater consistencies with KRS 45A while still promoting competitiveness.
- Created a notification and approval process for contracts by the Board.
- Revised the internal procedures for procurement, including the submission of personal service contracts to the Government Contract Review Committee.
- Named a new General Counsel who is responsible for facilitating the procurement process and working with the business units to ensure that the procurement policy is being followed.
- Implemented new contract management software to ensure all contracts and procurement documentation are stored and maintained in accordance with applicable internal policies.
- Facilitated mandatory procurement policy and procedures training for all management.
- Held Board committee meetings on a regular basis and provided updates and recommendations to the full Board for action.
- Decided to adopt Board committee charters that clearly define the purpose, duties and authority of each Board committee.
- Engaged the services of a human resources consulting firm to ensure management structure conforms to HR best practices.

KEMI
Kentucky Employers' Mutual Insurance

250 West Main Street, Suite 900 Lexington, KY 40507-1724 859-425-7800 www.kemi.com

Additionally, KEMI is re-evaluating our marketing and communication strategies to ensure they are focused on maintaining and developing business.

Generally, we agree with many of the findings noted in the report regarding governance and internal controls. Our actions prior to the issuance of your report reflect the same. However, the findings related to marketing, advertising, and business development do not take into consideration that we are statutorily required to function as a competitive insurance carrier and that we strive to be a good corporate citizen. Many of the examples you note in the report may seem without a business purpose to a state-created entity but may bring value to a competitive insurance company.

We look forward to continuing to review your recommendations and determine what actions are necessary to ensure that we meet our dual role of being a state-created entity and a competitive insurance company.

Within the sixty (60) day response period, we will provide additional comments and clarification regarding various details found in the audit. Additionally, we respectfully request the opportunity to further discuss the information contained in the report to ensure that we have a full understanding.

We continually look for opportunities to make improvements for the benefit of our policyholders. Thank you for your report.

Sincerely,

Jon E. Stewart
President & CEO

cc: KEMI Board of Directors