CALIFORNIA STATE AUDITOR

Bureau of State Audits

Joint Hearing of
House of Representatives
Committee on Oversight and Government Reform
and Subcommittee on Government Management,
Organization and Procurement

Statement by Elaine M. Howle
California State Auditor

March 5, 2010

TESTIMONY

Elaine M. Howle
State Auditor

Doug Cordiner
Chief Deputy

CALIFORNIA STATE AUDITOR
Bureau of State Audits

555 Capitol Mall, Suite 300 Sacramento, CA 95814 916.445.0255 916.327.0019 fax www.bsa.ca.gov

Joint Hearing of
House of Representatives
Committee on Oversight and Government Reform and
Subcommittee on Government Management, Organization and Procurement
March 5, 2010

Statement by Elaine M. Howle
California State Auditor

Chair and Members of the Committees:

I am pleased to be here today in Los Angeles at the California Science Center to discuss our State's implementation of the American Recovery and Reinvestment Act of 2009 (Recovery Act). My office is the State's independent and nonpartisan audit, evaluation, and investigative arm of the Legislature and Californians. In addition to conducting performance audits as requested or mandated by the Legislature, my office is required to annually conduct California's statewide Single Audit, which is a combination of the independent audit of the State's basic financial statements and the independent audit of numerous federal programs administered by California. The audit work conducted by my office is in accordance with audit standards issued by the United States Comptroller General/Government Accountability Office (GAO), including standards we must follow to qualify as an independent auditor. To preserve the independence of my office and to ensure the receipt of federal funds each year, state law requires my office to follow those standards and explicitly frees my office from control by the executive branch.

Moreover, my office is responsible for administering California's Whistleblower Protection Act, which gives my office the authority to conduct investigations into improper governmental

activities by state departments and employees during the performance of their duties. An "improper governmental activity" is any action that violates the law; is economically wasteful; or involves gross misconduct, incompetency, or inefficiency. Under this act, anyone can report to my office allegations of fraud, waste, and abuse involving public funds, including Recovery Act funds, and remain anonymous.

Though California like other states has benefited from the influx of Recovery Act funds, it has had its share of challenges—awarding and spending these fund with the speed contemplated in the Act, reporting the public benefits, and complying with other federal requirements governing the use of federal funds including Recovery Act funds. My office is among several oversight entities responsible for overseeing the State's administration of these federal dollars and suggesting changes to make sure California state departments comply with laws and regulations to avoid risking the loss or misuse of these precious dollars. Today I will provide the committee a description of the oversight activities my office has undertaken with respect to Recovery Act funds to achieve the unprecedented accountability and transparency objectives that are the cornerstone of the Recovery Act. Reports that my office has issued are available on the California State Auditor's Web site at www.bsa.ca.gov. I will also discuss the deficiencies we have identified related to the State's implementation of the Recovery Act with a focus on the Weatherization program, the State Energy program, and programs administered by California's departments of Education (Education) and Transportation. Finally, I will tell you about the changes and improvements California has made to ensure these Recovery Act funds are administered properly.

Background

On February 17, 2009, the president signed into law the Recovery Act to help fight the negative effects of the economic recession. The Recovery Act provides states, local governments, and other entities $787 billion intended to preserve and create jobs; promote economic recovery; assist those most affected by the recession; invest in transportation, environmental protection,

and other infrastructure; and stabilize state and local government budgets. It is estimated that California will eventually receive $85 billion from the Recovery Act with nearly $55 billion going to local entities and state departments and about $30 billion in the form of tax relief to Californians.

Accountability and transparency are the cornerstones of the Recovery Act. The federal Office of Management and Budget (OMB) in its initial guidance for implementing the Act directed federal agencies to immediately take critical steps to meet specific accountability objectives related to the Act. These objectives include transparency; awarding and distributing the funds in a prompt, fair, and reasonable manner; reporting clearly, accurately, and in a timely manner the public benefits of the funds; avoiding unnecessary delays and cost overruns of projects; and achieving program goals, such as program outcomes and improved results on broader economic indicators. The OMB updated its initial guidance to clarify existing provisions, such as those related to implementing the reporting requirements and to establish the steps to facilitate the accountability objectives of the Act.

The Recovery Act contains various reporting requirements for recipients including state and local governments. Most notably, Section 1512 of the Recovery Act requires certain recipients to report performance data quarterly beginning October 2009 with detailed information on the projects and activities funded by the Recovery Act. These reports are intended to provide the public with an unprecedented level of transparency into how federal dollars are being spent and to help drive accountability for the proper administration of Recovery Act dollars. Even though at this point the OMB has not provided specific guidance for auditing these reports, my office has reviewed the methods the state departments used to provide the data in the October 2009 reports.

The unprecedented transparency and accountability objectives of the Recovery Act require rigorous and continuous oversight. The federal government is relying on the Single Audit as its

primary tool to achieve the accountability objectives. My office has conducted the Single Audit since 1985 as required by California law. The Single Audit Act of 1984 was enacted to improve auditing and management of federal funds provided to state and local governments as well as promote sound financial management, including effective internal controls with respect to federal awards administered by state and local governments and nonprofits. In addition to internal controls, the Single Audit Act dictates that the audit focus on compliance with laws and regulations regarding federal awards. Compliance refers to how well the respective agency receiving federal funds adheres to the requirements in federal law, regulations, contracts, and grants applicable to each of its federal programs.

The OMB provides guidance for conducting the Single Audit of federal financial assistance programs, including those programs authorized or augmented by the Recovery Act. The number and type of federal programs audited each year as part of the Single Audit is formula-driven as required by the OMB. The OMB requires certain programs to be audited every year and others to be audited on a cyclical basis, both of which are considered major federal programs. The most recent Single Audit completed by my office covering state fiscal year 2007-08—before Recovery Act funding—includes 43 federal programs, which represented about 78 percent of the $76 billion in federal awards received by the State. With the huge influx of Recovery Act funding, my office will audit 55 programs representing about 97 percent of the $107 billion in federal awards, including Recovery Act funding California received during state fiscal year 2008-09.

Although initial estimates indicate that approximately $55 billion of Recovery Act funding would be allocated to California state and local governments through federal awards, California's receipt/expenditure of these funds is occurring at a much slower pace than originally anticipated. As a result, we expect significant receipt/expenditure of these funds to occur during state fiscal year 2009-10 and beyond making future Single Audits critical to the oversight of these Recovery Act dollars.

Oversight Activities

The enormous effort of successfully implementing the Recovery Act in an atmosphere of urgency and short timelines requires coordination of oversight at all levels of government. Among its many provisions, the Recovery Act directs the Recovery Accountability and Transparency Board (Recovery Board) to conduct oversight of federal agencies' handling of Recovery Act funds in order to prevent fraud, waste, and abuse and to coordinate its oversight activities with the GAO and state auditors. As such, shortly after the Recovery Act was signed into law, my office began coordinating with several entities by participating in regular conference calls with OMB, the U.S. Department of Health and Human Services (California's cognizant agency), the National State Auditors Association, and other state auditors to give and receive feedback regarding guidance for implementation of the Recovery Act and to discuss other Recovery Act-related issues. In fact, OMB requested that my office participate in a pilot project it established to provide management and those charged with governance useful, timely, and important information on internal control or compliance weaknesses so that identified deficiencies are corrected immediately. Representatives from the Recovery Board and the U.S. Department of Health and Human Services recently notified me that the interim reports published by my office are widely read at the federal level and posted on the www.Recovery.gov Web site.

The Recovery Act states that the federal funds authorized should be spent to achieve the purposes of the Recovery Act as quickly as possible, consistent with prudent management. As a result, in April 2009, shortly after the Recovery Act was signed into law, my office designated California's system for administering these funds a high-risk issue area and exercised our authority to initiate audits and conduct reviews. Given the vast amount of funds California expects to receive, the extensive requirements the Recovery Act places on recipients, the limited amount of time the State has to spend some of these funds, and the risk that California may lose Recovery Act funds if it fails to comply with the requirements, my office initiated

preparedness reviews and early testing of internal controls. In June 2009 OMB issued guidance emphasizing the importance of recipients of Recovery Act funds establishing effective internal controls over these funds, and encouraging auditors to promptly communicate internal control deficiencies to management and those charged with governance.

After designating the State's system for administering Recovery Act funds a high-risk issue area, my office increased its scrutiny of these funds by conducting oversight activities to help ensure California is prepared to properly administer these funds and is meeting federal requirements to avoid the risk of losing Recovery Act dollars. My office has and continues to perform the oversight activities listed below:

- Conducted risk assessments in April and July 2009 to identify the federal programs receiving Recovery Act funding and the administering state departments for which we would conduct preparedness reviews and early testing of internal controls. The risk assessments include factors such as an analysis of the portion of the Recovery Act funds that California expected to receive, the formula for determining which programs require an audit, the number and type of recurring internal control and federal compliance deficiencies previously reported, and whether the state departments had previously administered large federal programs. OMB guidelines require auditors to conduct a risk assessment to plan the traditional Single Audit work each year.

- Performed preparedness reviews and early testing of internal controls at departments identified through the risk assessments. To conduct the preparedness reviews, we used a questionnaire—developed using guidance from the OMB—interviewed key personnel, and reviewed supporting documents on the processes and procedures the departments intended to use to comply with federal requirements related to the Recovery Act funds. In addition, we reviewed our most recent Single Audit to identify relevant findings citing internal control weaknesses. Further, we performed limited testing of those control

weaknesses the departments asserted they had fully corrected to verify whether their assertions were accurate.

- Conducted interim testing and issued early reports on internal controls and federal compliance deficiencies, which consist of reporting the results of the traditional Single Audit work on those federal programs my office determined to be major programs and expected to receive Recovery Act funds. Rather than waiting to report the Single Audit results when the audit work for all major federal programs is complete, my office is publishing interim reports as we complete our audit work for each Recovery Act program as suggested by the OMB.

Results of Preparedness Reviews and Early Testing of Controls

As of February 2010 my office has published eight letters or reports (excluding the high-risk designation letter issued April 22, 2009) on the results of early testing and/or preparedness reviews conducted on 31 federal programs at 13 state departments administering multiple federal programs receiving Recovery Act funds. Following are a few highlights from these letters and reports specific to Recovery Act funding.

Department of Community Services and Development—Delays by Federal and State Agencies Have Stalled the Weatherization Program and Improvements Are Needed to Properly Administer Recovery Act Funds (2009-119.2, February 2, 2010)

The Recovery Act designated a national total of $5 billion for the Weatherization Assistance for Low-Income Persons (Weatherization) program of which the U.S. Department of Energy (Energy) awarded California almost $186 million in April 2009. By July 28, 2009, Energy made available nearly $93 million of the $186 million award to California. The remaining half, or $93 million, will be available if California demonstrates progress in implementing the program by meeting certain performance milestones. The performance measures used by Energy include states weatherizing 30 percent of all units estimated to be completed in the approved

program plans, states fulfilling monitoring and inspection protocols, acceptable progress reports submitted by states in accordance with grant requirements, and states conducting monitoring reviews to confirm acceptable performance.

The federal Weatherization program is designed to improve home energy efficiency for low-income families through the installation of weatherization materials such as attic insulation, caulking, weather stripping, furnace efficiency modifications or replacements, and air conditioners. In its administration of the Weatherization program, the California Department of Community Services (Community Services) provides program funds to nonprofit organizations and local governments to perform these weatherization assistance services. In addition, Community Services monitors the service providers for compliance with grant terms and conditions, and it may take enforcement action against these service providers.

The Weatherization program is one of five federal programs that the Joint Legislative Audit Committee—a bicameral, bipartisan legislative committee that approves and prioritizes audits requested by the Legislature—approved as part of an audit requiring my office to determine the extent to which Community Services is prepared to receive and administer Recovery Act funds awarded by Energy. Community Services was selected for review, in part, because historically California has received an average of about $6 million in federal awards for this program each year and under the Recovery Act the amount was significantly increased to $186 million.

In our report dated February 2, 2010, we concluded that startup of the Weatherization program has been delayed because federal oversight agencies and Community Services have not yet completed necessary tasks. Specifically, as we completed our fieldwork last December, Community Services told us that as of December 1 it had not weatherized any homes using Recovery Act funds even though nearly $93 million had been available since July 28, 2009. However, in its January 25, 2010 response to our report, Community Services asserted that

service providers had weatherized 210 homes with an additional 790 in the pipeline or the preparation stage. We have not been provided with any documentation to support these assertions. Furthermore, even if 210 homes had been weatherized, Community Services is far from its goal of weatherizing 1,433 homes per month. In addition, Community Services has not developed the cost-effective measures to weatherize homes using the Recovery Act funds, has been slow in negotiating agreements with service providers that cover grant terms such as cash management, and has not developed procedures for monitoring the additional requirements service providers must comply with when using Recovery Act funds.

Federal Agencies' Delays Have Stalled Implementation of the Weatherization Program

Delays in establishing minimum wage rates for weatherization workers and providing training by federal oversight agencies have stalled the implementation of the Weatherization program. Specifically, the U.S. Department of Labor (Labor) did not provide prevailing wage determinations for weatherization workers, as required by the Davis-Bacon Act, until September 3, 2009, and did not finalize wage rates until December 2009. The Davis-Bacon Act, which requires contractors and subcontractors for certain federally funded projects to pay their laborers no less than the prevailing wage rate as determined by Labor, did not apply to the Weatherization program until the passage of the Recovery Act. As a result, Labor had never before established classifications or prevailing wage rates for the Weatherization program workers.

On September 3, 2009, Labor announced the worker classifications and minimum wages that must be paid to California weatherization workers, but Energy did not provide guidance and training for preparing the payroll certifications necessary under the Davis-Bacon Act, until October 7, 2009. Furthermore, Labor revised the wage rates effective December 11, 2009, in part because some states' service providers and contractors notified Labor of a number of inconsistencies in the rates. According to Community Services, the service providers felt that the hourly rates were too high in specific cases. For example, the service providers felt that the

hourly rate determination of $62 per hour for workers performing heating, ventilation, and air conditioning work for five California counties was excessive. In the revised rate announcement, Labor reduced the minimum rate for this classification to $27 per hour.

Before a service provider can begin weatherizing homes, Community Services' policy requires them to submit for approval, plans for complying with the Davis-Bacon Act and the payroll reporting requirements, including the compliance plans for any subcontractors that the service provider intends to use. The service providers must also ensure that any subcontractor it uses complies with the Davis-Bacon Act and submit the subcontractor's compliance plan to Community Services for approval. However, because Labor did not finalize the wage rates until December 2009, and because Energy did not provide guidelines and training regarding the requirements for the Davis-Bacon Act until October 2009, Community Services could not approve either the service providers' or their subcontractors' plans for complying with the Davis-Bacon Act until very recently.

In addition, Community Services asserts that delays were partially the result of its inability to complete certain tasks while it waited for federal guidance. For example, Community Services had not yet identified and received approval from Energy for the weatherization measures that are allowable under the program. These are allowable weatherization measures based on climate zones and the Weatherization program's cost-effectiveness requirements. Community Services allowed providers to accept applications for weatherization assistance and perform assessments of the weatherization measures needed using the standards established for the program before it received Recovery Act funds, but Community Services advised its service providers that no weatherization work could begin until the measures were approved for the program using Recovery Act funds. Community Services is testing a computer modeling program that it plans to use to develop a list of priority measures to ensure the weatherization activities for each home meet Energy's cost-saving benefit requirement and had hoped to present the modeling program to Energy for approval within the two-month period following

the end of our fieldwork in December. In the meantime, for those service providers with signed contracts and approved plans to comply with prevailing wage requirements, they were allowed to begin weatherization activities using standards established last year.

Community Services' Weatherization Program Is Unlikely to Attain the Performance Milestones Set by Energy

Community Services asserts that it must meet certain performance milestones issued by Energy to gain access to the remaining $93 million Energy awarded California. For instance, Community Services reported that it has until September 30, 2010, to weatherize 30 percent of the total 50,080 homes, or 15,024 homes, in the State's approved plan for its Weatherization program—nearly the same number of homes that Community Services weatherized during the entire four-year period from 2005 through 2008 from Energy's previously existing Weatherization program. In this plan, Community Services initially estimated its service providers would weatherize the 50,080 homes at an average cost of $1,938 per home. However, Community Services advised the service providers to increase the average cost to $3,500 per home based on the likelihood that the number of weatherization measures allowed under the program would increase, the increase in the amount paid to workers based on the prevailing wages set by Labor, and the expectation that less funding from other federal programs would be used to pay for weatherization services. As we completed our fieldwork in December 2009, Community Services stated that it was conducting a survey of service providers the week of January 4, 2010, to obtain an estimate of the number of homes it believes it can weatherize based on the updated cost figures. In its January 25, 2010 response to our report, Community Services reported that it now believes that a total of 43,150 homes would be weatherized.

Community Services must also demonstrate to Energy that it has an effective monitoring plan, complies with quarterly reviews of each service provider's performance, and conducts an on-site review of each subrecipient within a year. Although Community Services says it has a

monitoring plan, it had not yet updated the plan to include additional areas of monitoring related to compliance with the Recovery Act's Davis-Bacon Act requirements. At the time of our fieldwork, Community Services was in the process of hiring a private company to perform the mandated inspections of homes after they are weatherized. Community Services also planned to update its monitoring plan to include Davis-Bacon Act requirements.

Community Services Has Executed Contracts With Only a Few Service Providers

Although no homes were weatherized as of December 1, 2009, Community Services had made progress in obtaining agreements with service providers. Of the $93 million available to it, Community Services retained $16.3 million for the State's administrative costs and to provide training and technical assistance to service providers. Of the remaining $76.6 million, Community Services records showed that it had awarded 36 grants totaling almost $54.8 million to service providers. As of December 22, 2009, Community Services had fully executed contracts and approved compliance plans for eight service providers, allowing them to begin weatherizing homes. Further, Community Services had approved compliance plans for eight additional service providers, but it had not yet executed contracts for them by the end of our fieldwork. The remaining 20 service providers had not yet submitted their compliance plans and could not begin weatherization activities.

Community Services had not awarded the remaining $21.8 million because of pending enforcement actions against three service providers and it needed to make alternative arrangements for five geographical regions—Los Angeles, Alameda, San Mateo, El Dorado, and Alpine—that were not represented when we concluded our fieldwork. The geographic regions include multiple service areas. Two service providers serving parts of the Los Angeles region opted out of their contracts; one felt it would be difficult to comply with Recovery Act requirements such as the Davis-Bacon Act, and the other opted out after Community Services identified findings during its audit of the service provider. As a result, few providers were ready

to begin weatherizing homes in California, and even those few were not using the final weatherization measures yet to be completed by Community Services and approved by Energy.

Community Services Needs to Improve Its Controls Over Cash Management for the Weatherization Program

Community Services is not complying with the federal requirement to minimize the amount of time between when cash is advanced and the subrecipient disburses the funds. Although federal regulations allow Community Services to provide cash advances under certain circumstances, Community Services and its subrecipients must follow procedures to ensure that the advances are made as close as possible to the time the subrecipient actually makes disbursements for program or project costs. We found that as of December 28, 2009, of the approximate $966,000 Community Services advanced to four subrecipients, roughly $748,000 was still outstanding, and $99,000 had been outstanding for over 100 days. Further, Community Services' cash management policy allows advances of Weatherization program funds to subrecipients without obtaining the required authorization. Specifically, Community Services' policy allows a subrecipient to receive a cash advance of 25 percent of the total grant award by providing a listing of the expenses that will be paid using the advance and certifying it has no other source of funds available. Under this policy, subrecipients are required to offset at least 30 percent of the cash advance against their expenditures within three months and the remaining balance within six months. Because of the extended period allowed by its policy for liquidating advances, Community Services is not complying with the federal requirement to minimize the amount of time between when the cash is advanced and when disbursement of funds takes place.

Finally, Community Services did not fully complete a required report to Energy for the reporting period ending September 30, 2009, because of access problems when it moved to a new location. As a result of the incomplete report, job creation data reported through the State's Recovery Act Web site does not match information submitted to Energy. And although it had

no weatherization activities to report, Community Services reported 81 jobs created or retained as a result of the training and technical assistance activities conducted by its contractor and the service provider network's efforts to start up the Weatherization program.

Recommendations

In this report we recommended that to ensure California receives the remaining 50 percent of the $186 million award, Community Services should seek federal approval to amend its plan for implementing the Weatherization program and seek an extension from Energy for fulfilling the progress milestones. Further, Community Services should promptly develop and implement the necessary standards for performing weatherization activities and develop a plan for monitoring subrecipients. Additionally, we recommended that Community Services ensure it has the authority to provide advances as outlined in its current policy so that it complies with federal cash management rules that govern the Weatherization program.

Audit Follow-Up

State law requires state agencies that my office audits to submit periodic status reports regarding the respective state agency's progress in implementing audit recommendations. In keeping with our longstanding practice, my office requires state agencies to submit these status updates 60 days, six months, and one year from the published date of the audit report. Using these status reports my office will track the progress that Community Services is making to implement the audit recommendations. The first status report is due on April 2, 2010; however, we have informed Community Services that it should submit its 60-day response to my office by mid-April so that it can include a report of the number of homes weatherized through March 31, 2010.

Interim Reporting: Fiscal Year 2008-09 Single Audit

California Department of Education: State Fiscal Stabilization Fund—Education State Grants, Recovery Act (2009-002.3, January 26, 2010)

California's public education system is administered at the state level by the State Department of Education (Education), under the direction of the State Board of Education and the superintendent of public instruction (superintendent), to educate approximately 6.3 million students in roughly 967 school districts. The primary duties of Education and the superintendent are to provide technical assistance to local school districts and to work with the educational community to improve academic performance.

Our most recent report on Education's administration of Recovery Act funding included a review of Education's portion of the State Fiscal Stabilization Fund (Stabilization Program). The Recovery Act provides the U.S. Department of Education $53.6 billion to administer the Stabilization Program of which the federal Education agency can allocate to states to support education and other governmental programs. The Recovery Act requires states to spend 81.8 percent of their allocation to support elementary, secondary, and postsecondary education, while spending the remaining 18.2 percent for public safety and other governmental services. In state fiscal year 2008-09, California received $2.8 billion under the Stabilization program. The Governor's Office of Planning and Research, the official state recipient of this funding, entered into an interagency agreement with Education to disburse $1.6 billion of the Stabilization Program funds to local educational agencies (LEAs)—such as school districts and county offices of education—to restore funding to K-12 education. In addition, California used $726.8 million for public safety, and the remaining $537 million was designated to restore funding to the University of California and the California State University systems.

Education Lacks Adequate Controls to Ensure All Interest Earnings on Program Advances are Appropriately Remitted to the Federal Government

Federal regulations require recipients and subrecipients of federal funds to promptly remit to the federal government interest earned in excess of $100 on program advances. These amounts must be remitted to the federal agency on at least a quarterly basis. However, Education lacks adequate policies and procedures to ensure LEAs that earn interest in excess of $100 remit such interest to Education who then can remit the interest to the federal government. Although Education notifies LEAs of this responsibility in its award notices, it does not have a process to monitor whether LEAs adhere to this requirement. During our audit, we found that LEAs have likely earned interest on over $1 billion in unspent federal funds because Education advanced $1.6 billion in program funds to LEAs by June 30, 2009, and reported that these LEAs had spent only $571.2 million as of September 30, 2009. After applying a conservative annualized interest rate of 1 percent, we estimate the LEAs may have earned nearly $2.5 million in interest from July through September 2009. In response to this finding, Education indicated that it has implemented new monitoring and tracking processes to facilitate the LEAs' compliance with federal interest requirements. Education also stated that it worked with the U.S. Department of Education to develop guidance for LEAs regarding federal interest requirements, which Education said it would provide to LEAs in late-January 2010.

Although Education indicated it has addressed this most recent deficiency related to cash management, it has a history of recurring cash management deficiencies that it may not have fully corrected. For example, despite repeated audit findings over several years, Education has not implemented an agency-wide cash management system that minimizes the time between LEAs' receipt and disbursement of federal funds. Shortly after the president signed the Recovery Act, my office conducted an assessment of the State's preparedness to administer Recovery Act funding at Education and three other state departments expected to receive significant amounts of Recovery Act funds in state fiscal years 2008-09 and 2009-10. These

departments intended to rely on existing internal controls to administer federal programs. However, my office identified 12 internal control deficiencies that may affect Education's ability to administer Recovery Act funds. These deficiencies were reported in previous audits my office conducted. In June 2009, when my office issued the first report assessing the State's preparedness to administer Recovery Act funds, Education had not fully corrected nine of these 12 deficiencies and had taken minimal or no action to correct two of the nine deficiencies. For example, we reported that Education had disbursed significant federal dollars to LEAs during state fiscal year 2007-08, with no assurance that these subrecipients minimized the time between the receipt and disbursement of these funds. Additionally, in its March 2009 report on Education's cash management practices, the inspector general for the U.S. Department of Education stated that Education had not implemented an agency-wide cash management system that minimizes the time elapsing between LEAs' receipt and disbursement of federal funds, despite repeated audit findings over many years. Education had not fully corrected three of the five internal control weaknesses regarding cash management identified in the Single Audit for state fiscal year 2007-08 and for two of those three it had taken minimal or no action to correct the weakness.

California Department of Transportation: Highway Planning and Construction
(2009-002.2, December 21, 2009)

The California Department of Transportation (Caltrans) administers the Highway Planning and Construction Program, which received more than $2.8 billion in federal funds of which approximately $1.2 million (less than 1 percent) is Recovery Act funding for fiscal year 2008-09. Caltrans uses federal funds under this program to make capital improvements to designated highways and to provide subgrants to cities and counties for similar projects. As of December 1, 2009, my office identified findings related to Caltrans' noncompliance with federal requirements concerning allowable costs and subrecipient monitoring.

Caltrans Has Recently Improved Its Procedures to Better Ensure That It Disburses Federal Funds to Local Agencies Only for Reasonable Costs

In 1992 the U.S. Department of Transportation—Federal Highway Administration (FHWA)—delegated to Caltrans the responsibility for authorization and oversight of certain federally funded projects, such as all highway projects not located on the National Highway System (NHS). For state-authorized projects that are developed and administered by local agencies, Caltrans agreed to provide the necessary review and oversight to assure compliance with federal requirements. However, during state fiscal year 2008-09, Caltrans lacked adequate internal controls to ensure that its progress payments—payments made while a project is ongoing—to local agencies were reasonable according to federal guidance. Specifically, Caltrans' accounting staff did not review local agency progress invoice packages to determine whether the costs claimed met federal eligibility requirements and did not verify that the work actually performed was consistent with the progress costs invoiced. In response to concerns raised by the FHWA, Caltrans changed its policy effective September 1, 2009, requiring engineers at the district offices to ensure that the work claimed on progress invoices was actually performed and eligible for reimbursement.

Caltrans' Jobs Data (for the October 2009 Quarterly Report) Seems Questionable Even Though It May Have Followed Guidance

Federal guidelines do not currently require us to, nor did we, audit the information recipients must report under Section 1512 of the Recovery Act. Nonetheless, in keeping with OMB's emphasis on early communication of issues to management, we conducted a high-level review of the methodology that Caltrans used to report the number of jobs created or retained with Recovery Act funds. Based on our preliminary review of Caltrans' October 2009 first quarterly reporting of nearly 1,590 jobs created or retained, we believe Caltrans followed the applicable guidance; however the number of jobs is overstated. Caltrans reported that it spent $26.7 million in Recovery Act funds to create or retain these jobs but acknowledged that the jobs figure was overstated for a variety of reasons, including that it counted jobs on some

construction projects twice. Furthermore, Caltrans reported jobs created or retained for 152 projects; but 94 of these projects representing 892 jobs created or retained had yet to spend any Recovery Act funds. Therefore, we also question the accuracy of the 892 jobs reported for these 94 projects. FHWA planned to review state's jobs data to check for errors, but it appears that FHWA did not validate the data.

Department of Corrections and Rehabilitation: State Fiscal Stabilization Fund Program—Government Services (2009-002.1b, November 23, 2009)

As previously mentioned, the Recovery Act allowed states to spend 18.2 percent of their stabilization program allocation for public safety and other government services, which may include educational programs. In the State's application for initial funding under the Stabilization Program, the governor indicated that California would use the entire government services portion of its allocation on public safety. The California's Department of Corrections and Rehabilitation (Corrections) administered this portion of the State Fiscal Stabilization Program.

Corrections' Use of Stabilization Funds to Reimburse Its Payroll Costs Was Appropriate

In the letter report my office published on November 23, 2009, we noted that of the $2.8 billion in stabilization funds the State had received by mid-June 2009, Corrections spent its entire $726.8 million (18.2 percent) to reimburse the State's General Fund for payroll expenses incurred during May and June 2009. Corrections' use of these funds in this manner is consistent with Recovery Act goals, which state that one of its main purposes is to preserve and create jobs. Also, according to the requirements for the State Fiscal Stabilization Fund Program, certain stabilization funds can be used for public safety. In its October 2009 report on jobs retained, Corrections indicated that it used these funds and an additional $328 million received in state fiscal year 2009-10 to retain the jobs of 18,229 correctional officers working in adult prisons throughout the State.

Corrections May Have Overstated the Number of Jobs It Retained Using Stabilization Funds

As previously mentioned, federal guidelines do not currently require us to audit the information recipients must report under Section 1512 of the Recovery Act. Nevertheless, in keeping with OMB's emphasis on early communication to management, we conducted a high-level review of the methodology Corrections used to report the number of jobs retained using stabilization funds. Based on our review, we believe Corrections may have overstated how many jobs it retained when it reported its 18,229 figure to the federal government in its quarterly report submitted in October 2009. At the time of our review, the federal government defined jobs retained as an existing position that would not have been continued were it not for Recovery Act funding. By simply reporting how many correctional officers' salaries were paid with Recovery Act funding, regardless of whether these positions were truly at risk of being eliminated without federal funding, Corrections methodology is not consistent with the federal government's definition of the term "jobs retained." Moreover, Corrections had issued 3,655 layoff notices on May 15, 2009, and between 1,300 and 1,450 additional notices in August 2009, according to various media reports, for a total of about 5,000 notices. As a result, the total number of layoff notices Corrections issued is less than one-third of the 18,229 jobs that it reported to the federal government.

California Energy Resources Conservation and Development Commission: It Is Not Fully Prepared to Award and Monitor Millions in Recovery Act Funds and Lacks Controls to Prevent Their Misuse (2009-119, December 1, 2009)

The Recovery Act designated a total of $3.1 billion for the federal Energy Program, which provides grants and technical assistance to state and U.S. territories to promote energy conservation and reduce growth of energy demand. The work to deploy new renewable-energy and energy-efficient technologies takes place in the states and is managed by the state energy offices. The state energy office for our State is the California Energy Resources Conservation and Development Commission (Energy Commission).

I previously discussed that California's Joint Legislative Audit Committee requested my office to conduct a review of California's preparedness to receive and administer Recovery Act funds for selected programs, including funds for the Energy Program. Keeping with our goal to communicate as early as possible the results of these reviews, my office reported on December 1, 2009, that the Energy Commission is not yet prepared to administer Recovery Act funding, leaving the State at risk to lose millions of federal dollars. More specifically, the report included the following information/findings related to the Energy Commission's administration of Recovery Act funds:

The Energy Commission Has Contracted for Only $40 Million of the $226 Million Awarded

In 2008, prior to the Recovery Act, the Energy Commission's award of federal funds for its Energy Program was about $3 million. In April 2009 the U.S. Department of Energy began awarding Recovery Act funds to the Energy Commission that totaled $226 million by September 2009. However, as of November 16, 2009, the Energy Commission had approved only $51 million for Energy Program services and of that amount had entered into two contracts totaling $40 million—$25 million to the Department of General Services (General Services) and $15 million to the Employment Development Department (Employment Development). The funds from these two contracts will be used to issue loans to state departments and agencies to retrofit state buildings to make them more energy efficient and to provide job skills training for workers in the areas of energy efficiency, water efficiency, and renewable energy. The contract with General Services was executed on October 5, 2009, and the contract with Employment Development was executed on November 2, 2009. As a result, except for approximately $71,000 that the Energy Commission spent on its own administrative costs, no other Recovery Act funds had been spent as of November 16, 2009.

The Energy Commission Is Moving Slowly to Complete Tasks Needed to Award and Monitor Funds

Although the Energy Commission had access to $113 million of its total award of $226 million since July 2009, it has been slow to develop guidelines, issue request for proposals (RFPs), and implement the internal controls needed to properly administer the Energy Program. More specifically, the Energy Program is comprised of eight subprograms, seven of which are new and required guidelines for subrecipients to follow when providing services. The Energy Commission had adopted guidelines for only four of the eight programs as of September 30, 2009. Similarly, as of November 16, 2009, the Energy Commission had released RFPs to potential recipients for only three of the six subprograms it intends to implement that require solicitation.

Because the Recovery Act requires that funds appropriated for the Energy Program be obligated by September 30, 2010, to avoid the potential of losing federal funds, the Energy Commission will have to develop program guidelines and issue RFPs in the next 10 months. In addition, because it lacks an established system of internal controls, the risk for fraud, waste, and abuse is increased. Because the Energy Commission has made little progress in implementing its subprograms, none of the Recovery Act funds are being used to provide benefits to Californians, such as preserving or creating jobs, promoting economic recovery, and assisting those most affected by the recession. Moreover, these Recovery Act funds will not likely be awarded to subrecipients until at least April 2010 to July 2010, based on the time frames provided by the Energy Commission. As such, it is imperative that the Energy Commission adhere to its timelines and time frames for executing grants, loans, and support services contracts; otherwise, it may risk losing federal funds.

The Current Internal Control Structure Is Not Sufficient

The Energy Commission has established a committee to manage overall implementation of the Recovery Act. In addition, it has established manuals and procedures for procuring contracts requiring subprograms to obtain approval for contracts greater than $10,000, thereby providing transparency regarding the use of Recovery Act funds.

However, the Energy Commission has acknowledged that it needs assistance to implement and administer the Recovery Act funds awarded for the Energy Program. In fact, the Energy Commission anticipates that it will have to contract for additional support services to administer the program, including services to help establish internal controls. We identified several areas in which the Energy Commission's existing internal controls are not adequate. For example, it could not demonstrate that its controls are sufficient to mitigate and minimize the risk of fraud, waste, and abuse, and to effectively monitor subrecipients' use of the Recovery Act funds. Further, we question whether the Energy Commission has sufficient staff to handle the increase in workload and whether its existing financial and operational systems can handle the additional stress associated with an increase in the volume of contracts, grants, and loans prompted by the infusion of Recovery Act funds. Finally, the Energy Commission reported that it did not have reporting mechanisms in place to collect and review the data required to meet the Recovery Act transparency requirements.

Any delay in procuring the services to establish an internal control structure to adequately address the risks of administering Recovery Act funds increases the risk of delays in implementing the subprograms, possibly hindering the Energy Commission's ability to obligate Recovery Act funds before the September 30, 2010, deadline. Alternatively, awarding these funds without having adequate systems in place increases the possibility that Recovery Act funds will not be used appropriately, heightening the potential for fraud, waste, and abuse to occur.

In this report we recommended that as soon as possible, the Energy Commission take the steps necessary to implement a system of internal controls adequate to provide assurance that Recovery Act funds will be used to meet the purposes of the act. These controls should include those necessary to collect and verify the data needed to measure and report on the results of the programs funded by the Recovery Act and to mitigate the potential for fraud, waste, and abuse. Such steps should include quickly performing the actions already planned, such as assessing the Energy Commission's controls and the capacity of its existing resources and systems, and promptly implementing all needed improvements. Further, the Energy Commission should promptly solicit proposals from entities that could provide the services allowable under the Recovery Act and should execute contracts, grants, or loan agreements with these entities.

In its initial response to the audit report, the Energy Commission agreed that additional internal controls should be implemented to meet the Recovery Act requirements and that further work is needed to finalize its preparations to disburse funds for the Energy Program. The Energy Commission pointed out that it must comply with numerous state laws and regulations, including those that require due public process for adopting regulatory requirements and others requiring it to make all decisions in an open public setting with ample opportunity for public input. According to the Energy Commission, the U.S. Department of Energy has stated California is not at risk to lose funds.

The Energy Commission submitted its 60-day response on February 1, 2010, asserting that it is strengthening its internal controls through contracting efforts and thus far it has received multiple responses to solicitations for Program Auditing and Consultant services and services for Monitoring, Evaluation, Verification and Reporting. The Energy Commission expects both contractors to start work in the March/April 2010 time frame. The Energy Commission also asserts that it has made significant progress implementing newly created programs and

awarding Recovery Act funds and its timeline for full obligation of the Recovery Act funds remains on target and within the parameters of the law.

CONCLUDING REMARKS

Thank you for the opportunity to report on California's administration of the Recovery Act funding. One general principle of the Recovery Act is that the funds be used to achieve its purposes as quickly as possible using sound and prudent management. My office will continue to provide management and those charged with governance with critical information necessary to ensure the proper administration of Recovery Act funds the federal government has made available to California. My office will also continue to monitor the corrective action taken to address the deficiencies identified in our reports and letters. However, program management and the State's administration must remain diligent in their efforts to comply with the federal requirements for these Recovery Act funds so that California receives every dollar available to Californians and that those dollars are used as efficiently and effectively as possible.