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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As authorized by Chapter 251, Statutes of 2004, the Bureau of State Audits (bureau) presents its analysis concerning the addition of the State's system for administering federal funds received under the American Recovery and Reinvestment Act of 2009 (Recovery Act) to its list of high-risk issue areas. As discussed in the enclosed analysis, the bureau has in the past identified internal control concerns related to state agencies' administration of federal programs. Because of these concerns and the vast amount of funds California expects to receive under the Recovery Act in the current and next fiscal year, the extensive requirements the Recovery Act places on recipients of these funds, 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, the bureau believes the State's system for administering the Recovery Act's funds represents a high-risk issue area.

Because we have designated the State's system for administering the Recovery Act's funds as high risk, we will exercise the bureau's authority to initiate audits of areas of high risk and conduct a review of the State's and selected departments' readiness to comply with applicable federal Recovery Act requirements.

Respectfully submitted,



Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

Enclosure

California's System for Administering Federal Recovery Act Funds

Given the vast amount of federal funds that California expects to receive under the federal American Recovery and Reinvestment Act of 2009 (Recovery Act) in the current and next fiscal year, the extensive requirements the Recovery Act places on recipients of these funds, the risk of California losing Recovery Act funds if it fails to comply with the requirements, and the existence of previously identified concerns related to certain state agencies' internal controls over their administration of federal programs, we believe that the State's system for administering the Recovery Act's funds is a statewide high-risk issue area.

The federal government enacted the Recovery Act to help fight the negative effects of the United States' economic recession. According to the Recovery Act, its purposes include preserving and creating jobs; promoting economic recovery; assisting those most affected by the recession; investing in transportation, environmental protection, and other infrastructure; and stabilizing state and local governmental budgets. The federal government intends to disperse approximately \$787 billion to recipients, including states and local governments, under the Recovery Act.

The Recovery Act imposes significant requirements on entities that receive the funds and penalties for noncompliance. For instance, Section 1512(c) of the Recovery Act requires recipients to submit to the federal government a report containing several pieces of information not later than 10 days after the end of each calendar quarter. The act also mandates that as a condition of receiving funds, federal agencies will require recipients to provide this information. The required information includes the amount of recovery funds received, the amount of recovery funds spent or obligated, a detailed list of the projects on which recipients spent or obligated recovery funds, an estimate of the jobs created and the number of jobs retained by the project or activity, and the infrastructure investments made by the recipients. Further, Recovery Act funds must be spent quickly; for certain programs, these funds are available only until September 2010.

California stands to receive a large share of the funds being made available under the Recovery Act. According to the California Economic Recovery Portal Web site (Recovery Portal), California's estimated share of the Recovery Act funds will be \$81.4 billion, \$35.4 billion of which will be in the form of tax relief to Californians. As of April 13, 2009, the Recovery Portal indicated that for fiscal years 2008-09 and 2009-10, \$29 billion will go to state entities or be shared among state entities and non-state entities to implement the Recovery Act's provisions. Another \$5.8 billion will be split among federal and non-state entities. It has not yet been determined which state or local entities will receive the remaining \$11.2 billion. The Recovery Portal indicates that 14 state entities could receive Recovery Act funds in fiscal year 2008-09, at least three of which are expected to receive over \$300 million each.

Given the large amount of funds that California expects to receive under the Recovery Act and the significant requirements imposed by the act, we examined prior audit reports to see whether they identified concerns related to internal controls. We examined the most recently available Single Audit report we issued—covering fiscal year 2006-07—and the most recently available audit reports that state entities issued under the Financial Integrity and State Manager's Accountability Act of 1983 (FISMA). According to the Department of Finance, the FISMA was enacted to reduce the waste of resources and strengthen accounting and

administrative control. State law requires certain state agencies to conduct an internal review and prepare a report on the agency’s internal accounting and administrative controls every two years.

As shown in the Table, we identified 46 findings in the fiscal year 2006–07 Single Audit report that related to internal controls over federal funds for the state entities shown. Two of the entities shown in the Table, the Secretary of Education and the Office of Planning and Research, did not administer federal grants that we audited as part of the Single Audit for fiscal year 2006–07. Examples of internal control findings we reported included the Employment Development Department did not follow the U.S. Department of Labor’s instructions for reporting training costs for one of its federal programs and could not demonstrate the accuracy and completeness of the information it received from its field offices that was used to calculate several figures ultimately reported to the federal government.

Table
Internal Control Findings for State Entities Expected to Receive in Excess of \$300 Million in Funds From the American Recovery and Reinvestment Act of 2009 by the End of Fiscal Year 2008–09

	AMOUNT OF RECOVERY ACT FUNDS THE STATE EXPECTS CERTAIN ENTITIES TO RECEIVE (DOLLARS IN MILLIONS)*	AREA WHERE THE INTERNAL CONTROL FINDING WAS IDENTIFIED					TOTAL NUMBER OF FINDINGS
		ACTIVITIES ALLOWED/ ALLOWABLE COSTS	CASH MANAGEMENT	ELIGIBILITY	REPORTING	SUBRECIPIENT MONITORING	
Department of Social Services	\$332.4	2	0	0	0	2	4
Employment Development Department	1,800.5	2	0	1	2	0	5
Department of Health Care Services	3,286.9	6	0	5	2	2	15
Secretary of Education, Department of Finance, and Office of Planning and Research†	5,202.5	2	6	1	6	7	22
Totals	\$10,622.3	12	6	7	10	11	46

Sources: Bureau of State Audits’ (bureau) Internal Control and State and Federal Compliance Audit Report for the fiscal year ended June 30, 2007. We obtained dollar amount information from the California Economic Recovery Portal Web site as of April 13, 2009.

* The dollar amounts shown here include only those amounts expected to be provided directly to the state entities or to be shared between state entities and non-state entities.

† The bureau did not review federal grants administered by the Secretary of Education or the Office of Planning and Research for fiscal year 2006–07. The internal control weaknesses in this row include one cash management finding at the Department of Finance and 21 findings at the California Department of Education (Education). We included Education’s findings in this row because it appears likely that it will be involved in administering a significant portion of the \$5.2 billion expected for these state entities.

Similarly, for a federal program at the Department of Health Care Services, we reported that business users (who did not have any system administration responsibilities) had full, unrestricted administrative access to a database used by the program. We determined that administrative users had the ability to change data and disable any controls on the system, thereby removing the ability to trace actions of the user.

We also noted internal control concerns raised as part of the FISMA reviews. For instance, the FISMA report for the Department of Social Services stated that the department, among other weaknesses, had inefficient and costly internal controls over cash receipts, lacked a comprehensive information technology solution to manage accounts receivable and cash receipts, and was late in recording manual cash disbursements.

Because of the concerns related to internal controls, the large amounts of Recovery Act funds California is expected to receive, the requirements the federal government is imposing on recipients, and the limited time the State has to spend some of the funding, we designate California's system for administering federal Recovery Act funds as a statewide high-risk issue area. Thus, we will exercise the bureau's authority to initiate audits of areas of high risk and conduct a review of the State's and selected departments' readiness to comply with applicable federal Recovery Act requirements.