

Joint Legislative Audit Committee Informational Hearing

American Recovery and Reinvestment Act of 2009 A Review of the State Auditor's Compliance Reports

January 20, 2010

As described in my testimony for the May 2009 JLAC hearing, my office annually conducts California's Statewide Single Audit, a combination of the independent audit of the State's basic financial statements and the independent audit of numerous federal programs administered by California. Both the Government Accountability Office (GAO) and the U.S. Office of Management and Budget (OMB) have stated that "the single audit process is a major accountability vehicle" and that it should be used as a starting point for reviews and assessing risk to identify vulnerabilities or high-risk programs. At the hearing in May, I shared some findings from the Single Audit for fiscal year 2007-08, the most recent fiscal year completed, and highlighted certain recurring audit findings. In addition, I shared my office's projections for the fiscal year 2008-09 Single Audit work including interim testing and reporting and coordinating with other federal oversight entities. Today, I will provide the committee a brief overview of the Recovery Act's objectives, some of its requirements, as well as an update on the activities and audit work my office has conducted since May.

Overview

On February 17, 2009, the president signed into law the American Recovery and Reinvestment Act of 2009 (Recovery Act) to help fight the negative effects of the economic recession. The Recovery Act is 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 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 OMB in its initial guidance for implementing the Recovery 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.

Section 1512 of the Recovery Act requires certain recipients to report performance data 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. The next reporting deadline was scheduled for January 15, 2010, but it has been postponed to January 22, 2010. At this point, OMB has not provided specific guidance for auditing these reports; however, we expect to receive such guidance in the near future.

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. In April, shortly after the Recovery Act was enacted, 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 in this area. With 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 establishing effective internal controls over these funds and encouraging auditors to promptly communicate internal control deficiencies to management and those charged with governance.

Shortly after the enactment of the Recovery Act, my office started participating in regular conference calls with OMB, the U.S. Department of Health and Human Services (California's cognizant agency), the National State Auditor's 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 recently 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. The Recovery Accountability and Transparency Board (board) and a representative from 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 the board intends to post them on its Web site.

Oversight Activities

After designating the State's system for administering Recovery Act funds a high-risk issue area, my office conducted the oversight activities listed below to make sure the State is prepared to properly administer these funds and is meeting federal requirements to avoid the risk of losing these Recovery Act dollars. Additionally, the Joint Legislative Audit Committee approved an audit to conduct preparedness reviews and early assessments of internal controls of Recovery Act programs at certain state departments including the State Energy Program administered by the California Energy Resources Conservation and Development Commission (Energy Commission).

- OMB guidelines require auditors to conduct a risk assessment to plan the traditional Single Audit work each year. My office conducted risk assessments in April and July 2009 to identify the Recovery Act programs and administering state departments for which we would conduct early testing and reviews. The risk assessments included factors such as the amount of Recovery Act funds the state departments expected to receive, the number and type of recurring internal control and federal compliance deficiencies, and whether the state departments had previously administered large federal programs.
- Preparedness reviews and early testing of internal controls were conducted at state departments we identified through the risk assessment. 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.

- Interim testing and early reporting on internal controls and federal compliance requirements consist of reporting the results of the traditional Single Audit work on those federal programs that are determined to be major programs and expect 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.

Early Testing and Reporting

Attachment 1 provides a snapshot of some of the information my office has reported on the Recovery Act funding. As of December 2009, my office has published five letters or reports (excluding the high-risk designation letter) on the results of early testing and/or preparedness reviews conducted on 25 Recovery Act programs at nine state departments that are administering multiple Recovery Act programs. Following are a few highlights from these letters and reports specific to Recovery Act funding.

HIGH RISK ASSESSMENT/Preparedness Reviews

- ✓ **June 24**—Our first report on the State’s preparedness to administer Recovery Act funding focused on four state departments: Education, Health Care Services, Employment Development, and Social Services. We reported that these departments intended to rely on existing internal controls to administer federal programs; however, in previous audits we had identified 30 deficiencies in those controls, 26 of which had not been corrected. For example, neither Social Services nor EDD conducted on-site reviews of subrecipients of federal funds and Education conducts on-site reviews of local educational agencies only once every four years. Further, despite repeated audit findings over several years, Education had not implemented an agency-wide cash management system that minimized the time between local educational agencies’ receipt and disbursement of federal funds.

Further, our report disclosed that some departments were uncertain as to whether they would be able to meet the new Recovery Act reporting requirements while others believed they were exempt from certain reporting requirements. In addition, none of the four departments or the California Federal Economic Stimulus Task Force (Task Force) had received sufficient guidance from the federal government regarding the Recovery Act's Section 1512 reporting requirements. We also noted that the Task Force had not provided state departments specific guidance on areas such as reporting the use of Recovery Act funds or how to coordinate with the State Controller's Office to establish a unique account number for tracking Recovery Act funds separately. We made numerous recommendations to the Task Force and the departments aimed at strengthening the State's preparedness to administer Recovery Act funds appropriately and prudently.

(Report 2009-611.1—High-Risk Update: California's System for Administering Federal Recovery Act Funds: State Departments Are Preparing to Administer Aspects of the Recovery Act Funding, but Correction of Control Weaknesses and Prompt Federal and State Guidance Are Needed)

INTERIM REPORTS FOR THE FISCAL YEAR 2008-09 SINGLE AUDIT

- ✓ **November 23**—The Department of Developmental Services' (Developmental Services) administration of two Special Education programs—Grants for Infants and Families. In this letter report, we identified five findings—one of which relates to requirements under the Recovery Act while the other four are repeat findings we have reported in previous Single Audits. In regards to the Recovery Act finding, we noted that Developmental Services did not ensure it disbursed Recovery Act funds only to subrecipients that met federal contractor registration requirements. More specifically, it did not ensure that regional center subrecipients were registered in the federal database or had Data Universal Numbering System (DUNS) numbers before disbursing \$16.6 million in Recovery Act funds. Federal regulations for the Recovery Act require subrecipients to maintain current registration at all times in a federal database called the Central Contractor Registration—the federal government's primary contractor database—and to have a unique number to identify a specific entity in Dun and Bradstreet's database. Developmental Services said it had not verified whether its regional center subrecipients had registered or received DUNS numbers because it was still determining whether these requirements are applicable. We recommended that Developmental Services ensure that its

subrecipients maintain current registration and obtain DUNS numbers before it disburses Recovery Act funds. **(Letter Report 2009-002.1a)**

- ✓ **November 23**—The Department of Corrections and Rehabilitation’s (Corrections) administration of a portion of the State Fiscal Stabilization Fund Program (Stabilization Fund). In this letter report 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) portion of these funds 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 Stabilization Fund, 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 fiscal year 2009-10 to retain the jobs of 18,229 correctional officers working in adult prisons throughout the State.

- ✓ 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 that Corrections may have overstated how many jobs it retained when it reported its 18,229 figure to the federal government. The federal government defines *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 according to various media reports, between 1,300 and 1,450 additional notices in August 2009, 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. **(Letter Report 2009-002.1b)**

✓ **December 21**—Our latest report focused on eight federal programs administered by five departments: Employment Development, Health Care Services, Rehabilitation, Social Services, and Transportation. Although not all are specific to Recovery Act funding, we identified 24 findings regarding the departments' administration of federal programs during our most recent Single Audit covering fiscal year 2008-09 federal awards. In many cases, the findings were recurring issues identified in past audits. Of the five departments, only two—the Department of Rehabilitation and the Department of Transportation—reported jobs created or retained. According to federal guidelines, the remaining three departments were not subject to these reporting requirements. The Department of Rehabilitation followed federal guidance and reported 13 jobs created or retained; however, the 1,590 jobs the Department of Transportation reported as created or retained is overstated by at least 390.

- At **Employment Development**, we reported that the department could not account for or track all of the Recovery Act funds it spent in fiscal year 2008-09 under the Unemployment Insurance program. Though Employment Development could identify that it spent \$471.9 million for the one component of the Unemployment Insurance program funded exclusively by the Recovery Act to add \$25 a week to recipients, it could not separately identify how much of the approximately \$4 billion it spent on two other components of the program funded with Recovery Act dollars. These two components were intended to provide California's unemployed workers with additional weeks of benefits.
- **Health Care Services** received \$24.9 billion for the Medical Assistance Program (Medi-Cal), including \$2.8 billion in Recovery Act funds. We identified seven findings related to the department's administration of the Medi-Cal program and like many of those previously mentioned, five were repeat findings. The audit findings generally focused on whether Health Care Services made proper eligibility determinations and spent program funds only on allowable costs.
- In fiscal year 2008-09, the **Department of Rehabilitation** had not spent any of the \$56.5 million awarded to it under the Recovery Act for the Vocational Rehabilitation Grants to States Program. However, we identified five findings that could affect Rehabilitation's administration of these funds in fiscal year 2009-10 and beyond. In general, these findings focused on federal requirements pertaining to the activities allowed, eligibility, reporting, and matching requirements. Our preliminary review of

Rehabilitation's description of its methodology to report 13 jobs created or retained indicates that Rehabilitation appears to have followed applicable federal guidance for reporting job-related data under Section 1512 of the Recovery Act.

- At **Social Services** we identified nine findings—eight are recurring audit findings—related to its administration of four programs that have been awarded Recovery Act funds during fiscal year 2008-09 including: the State Administrative Matching Grants for Supplemental Nutrition Assistance Program (SNAP), Temporary Assistance for Needy Families (TANF) program, Foster Care—Title IV-E program, and the Adoption Assistance Program. All of these programs were collectively awarded \$6.2 billion, including Recovery Act funds totaling \$307.1 million during fiscal year 2008-09, and Social Services spent roughly \$36.8 million of the Recovery Act funds on two of these programs. The findings we reported relate to a variety of different federal regulations including those governing allowable activities and subrecipient monitoring. For example, Social Services reimbursed counties approximately \$5.3 billion for these four programs in fiscal year 2008-09, but it did not conduct any on-site reviews to ensure the counties were spending federal funds only on allowable activities. This is a recurring finding we reported in last year's Single Audit report.
- The **Department of Transportation** administers the Highway Planning and Construction Program, which received more than \$2.8 billion in federal funds of which approximately \$1.2 million is funding provided by the Recovery Act in fiscal year 2008-09. We found noncompliance with federal requirements related to allowable costs and subrecipient monitoring. For example, until it changed its policy in September 2009, Transportation lacked effective controls to ensure that the progress payments it made to local agencies were reasonable and necessary. It now requires engineers in its district offices to verify that work claimed on progress invoices was actually completed and eligible for reimbursement. Further, based on our preliminary review of Transportation's October 2009 reporting of nearly 1,590 jobs created or retained, we believe Transportation followed the applicable guidance; however, the number of jobs is overstated. Transportation 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, Transportation reported one or more 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. The Federal Highway Administration (FHWA) planned to review the states' jobs data to check for errors, but it appears that FHWA did not validate the data.

JLAC Approved Audit: State Energy Program

December 1—As I previously mentioned, this committee requested that my office conduct a review of California's preparedness to receive 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 that the Energy Commission is not yet prepared to administer Recovery Act funding, leaving the State at risk to lose millions of dollars. (See Attachment 2 summarizing Energy Commission's preparedness.) More specifically, the report included the following information/findings related to the Energy Commission's administration of Recovery funds:

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

Prior to the Recovery Act, the Energy Commission's award of federal funds was only \$3 million in 2008. 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 services and contracted for only \$40 million, \$25 million to the Department of General Services and \$15 million to the Employment Development Department. 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 have been spent as of October 31, 2009.

The Energy Commission is Moving Slowly to Complete Tasks Need 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 require guidelines for subrecipients to follow when providing services. The Energy Commission had not adopted guidelines for four of the programs as of September 30, 2009. The combined Recovery Act funds available for these four programs could reach \$130 million. Similarly, as of November 16, 2009, the Energy Commission had released solicitations to potential recipients for three of the six subprograms it intends to implement that require solicitation.

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 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 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 adequate systems in place increases the possibility that Recovery Act funds will not be used appropriately, heightening the risk of fraud, waste, and abuse.

RECOMMENDATIONS TO THE ENERGY COMMISSION

To provide assurance that Recovery Act funds will be used to meet the purposes of the Recovery Act, the Energy Commission should:

- Quickly perform actions already planned, such as assessing the Energy Commission's existing controls and the capacity of its existing resources and systems and promptly implement all needed improvements.
- Develop controls necessary to collect and verify the data needed to measure and report on the results of the programs funded by the Recovery Act.
- Design controls to mitigate the potential for fraud, waste, and abuse.
- Promptly solicit proposals from entities that could provide the services allowable under the Recovery Act and execute contracts, grants, or loan agreements with these entities.

(California Energy Resources Conservation and Development Commission: It Is Not Fully Prepared to Award and Monitor Millions in Recovery Act Funds and Lack Controls to Prevent Their Misuse, Letter Report 2009-119.1)

CONCLUDING REMARKS AND FUTURE PLANS

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. As presented in this testimony, my office has conducted risk assessments, interim testing, and provided early communication of issues and weaknesses we identified to those charged with governance. Our goal is to provide management with critical information necessary to ensure the proper administration of Recovery Act funds the federal government has made available to California. My office will continue to provide these early communications of audit results and monitor the corrective action taken to address the deficiencies identified in these reports and letters. In addition, we plan to continue performing risk assessments as federal guidance is issued and Recovery Act funds flow to the State. Finally, program management and the administration must be diligent in their efforts to comply with the federal requirements for these Recovery Act funds so that the State receives every dollar available to Californians and that those dollars are used as efficiently and effectively as possible.

Attachment 1

ARRA Interim Reports Overview

DEPARTMENTS	PROGRAMS REVIEWED	ARRA FUNDS ONLY			NUMBER OF FINDINGS	NUMBER OF REPEAT FINDINGS	1512 REPORTS	
		ESTIMATED AWARD	AMOUNT RECEIVED 2008/09	AMOUNT SPENT			REPORTED NUMBER OF JOBS CREATED/ RETAINED	ACCURATE REPORTING
2009-002.1a (November 2009)								
Developmental Services	Special Education--Grants for Infants and Families Program	\$53 million	0	0*	5	4		
2009-002.1b (November 2009)								
Corrections and Rehabilitation	State Fiscal Stabilization Fund Program--Government Services	\$1.1 billion	\$726.8 million	\$726.8 million	1	n/a	18,229	N
2009-119.1 (December 2009)								
Energy Commission	State Energy Program	\$226 million	\$113 million	none†	n/a			
2009-002.2 (December 2009)								
Employment Development	Unemployment Insurance	unidentified		≥\$471.9 million	1	‡	n/a	
Health Care Services	Medical Assistance (Medi-Cal)	no award letter, award based on claims	\$2.8 billion		7	5	n/a	
Rehabilitation	Rehabilitation Services--Vocational Rehabilitation Grants to State	\$56.5 million	0	0	5	‡	13	Y
Social Services					9	8	n/a	
	1. State Administrative Matching Grants for the Supplemental Nutrition Assistance	\$10.1 million	0	0			n/a	
	2. Temporary Assistance for Needy Families	\$246 million	0	0			n/a	
	3. Foster Care--Title IV-E	\$20 million	0	0§			n/a	
	4. Adoption Assistance	\$30 million	0	0			n/a	
Transportation	Highway Planning & Construction	\$2.6 billion	\$1.2 million		2	‡	1,590	N

* Developmental Services did not draw down any ARRA funds in FY 2008/09. However, it drew down \$16.7 million in ARRA funds in September 2009 and applied it to FY 2008/09 expenditures.

† Energy Commission has awarded contracts totaling \$40 million, however, none of the \$40 million has been spent.

‡ The Bureau of State Audits has not audited these programs within the last two years.

§ Social Services did not draw down any ARRA funds in FY 2008/09 for this program, but did incur \$14 million in costs that it plans to pay with ARRA funds.

|| Social Services did not draw down any ARRA funds in FY 2008/09 for this program, but did incur \$22.1 million in costs that it plans to pay with ARRA funds.

Attachment 2

Table 2
Summary of the California Energy Commission's Preparedness to Administer Funding Received Under the Recovery Act

AREA OF PROGRAM RISK	LEVEL OF PREPAREDNESS
Human Capital	
Sufficient staff are available	✗
Staff are trained	◻
Financial and Operational Systems	
Separate accounting is maintained for Recovery Act funds	◊
Systems are configured properly	✗
Systems can handle volume	✗
Fraud, Waste, Abuse	
Controls are in place to prevent misuse of funds	◻
Policies and Procedures	
Recovery Act provisions have been incorporated	✓
Cash management procedures are in place	✗
Eligibility determination policies and procedures are in place	◻
Corrective action processes are in place	◻
Recipient guidelines are in place	◊
Acquisitions/Contracts	
Requests for proposals contain Recovery Act provisions	✓
Awards are prompt and fair	◻
Proper terms are included	✓
Costs are controlled to prevent overruns	◻
Awards are transparent to public	✓
Public benefits are reported	◻
Transparency and Accountability	
Governance body is established	◻
Data elements are identified	✗
Reporting mechanisms are established to collect data	✗
Reports are reviewed	✗
Reports are prepared on a timely basis	✗
Recipients are monitored	✗

Note: For detailed descriptions of the legend refer to pages 21 and 22.

- ✓ = Prepared
- ◊ = Mostly prepared
- ◻ = Moderately prepared
- ✗ = Not prepared