

## Interim Reporting: Fiscal Year 2009–10 Single Audit

Employment Development Department  
Health Care Services  
Transportation  
Veterans Affairs

January 2011 Report 2010-002.2



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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](http://www.bsa.ca.gov)

January 27, 2011

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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:

Pursuant to guidance issued by the U.S. Office of Management and Budget (OMB), the California State Auditor's Office (State Auditor's Office) presents its interim report concerning various state departments' administration of federal programs during fiscal year 2009–10. With the passage of the American Recovery and Reinvestment Act of 2009 (Recovery Act) comes a renewed emphasis on accountability and public transparency to ensure federal funds are spent properly. A key component of such accountability and transparency is the annual report from the State Auditor's Office on internal control and compliance with federal laws and regulations. OMB's June 2010 guidance stresses the importance of auditors communicating promptly any identified internal control deficiencies to management and those charged with governance. In addition, the guidance states that it is imperative that deficiencies in internal control be corrected by management as soon as possible to ensure proper accountability and transparency for expenditures of Recovery Act awards.

This interim report summarizes audit results pertaining to 14 federal programs administered by four departments. Three of the four departments received Recovery Act funding during fiscal year 2009–10. The State Auditor's Office has currently identified 17 findings regarding the four departments' administration of these federal programs during fiscal year 2009–10. In many cases the findings are recurring issues we identified in past audits. The findings focused on various federal requirements including those regarding eligibility and reporting. We also reported that the departments fully corrected six findings that we included in last year's annual audit report. The specific federal programs, and their administering state departments, are listed in the table of contents.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

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## Summary

### Results in Brief

On February 17, 2009, the federal government enacted the American Recovery and Reinvestment Act of 2009 (Recovery Act) to help fight the negative effects of the United States' economic recession. California expects that over time its state departments and other entities located within the State will receive \$85 billion in Recovery Act funding. With this increased funding comes a strong emphasis on accountability and public transparency to ensure federal funds are spent properly. A key component of such accountability and public transparency is the California State Auditor's Office (State Auditor's Office) annual report on the State's compliance with federal requirements, such as those identified in the Recovery Act.

The State Auditor's Office prepares its annual report in accordance with the requirements described in the U.S. Office of Management and Budget's (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. In June 2010 OMB encouraged auditors to communicate promptly any identified internal control deficiencies to management and those charged with governance. By encouraging prompt communication, OMB intends for recipients, including states, to correct these findings as soon as possible to ensure proper accountability and transparency for expenditures of Recovery Act awards. Based on OMB's June 2010 guidance, the State Auditor's Office presents its interim report concerning the State's administration of selected federal programs. Although OMB's guidance regarding prompt communication focused on Recovery Act programs, we have also included audit results for a department that did not receive Recovery Act funding in the interests of maximizing the benefits of prompt communication.

This interim report summarizes audit results pertaining to 14 federal programs administered by four departments. Three of the four departments received Recovery Act funding during fiscal year 2009–10. The State Auditor's Office has currently identified 17 findings regarding the four departments' administration of these federal programs during fiscal year 2009–10. In many cases the findings are recurring issues we identified in past audits. The findings focused on various federal requirements including those regarding eligibility and reporting. We also reported that the departments fully corrected six findings that we included in last year's annual audit report. Finally, we made numerous recommendations to the respective departments.

**The Employment Development Department (EDD)** administers several programs that have been awarded funds from the Recovery Act during fiscal year 2009–10 including: Unemployment Insurance (Federal Catalog Number 17.225); the Employment Service cluster, which includes Employment Service/Wagner-Peyser Funded Activities (Federal Catalog Number 17.207), the Disabled Veterans' Outreach Program (Federal Catalog Number 17.801), and the Local Veterans' Employment Representative Program (Federal Catalog Number 17.804); and the Workforce Investment Act (WIA) cluster, which includes the WIA Adult Program (Federal Catalog Number 17.258), WIA Youth Activities (Federal Catalog Number 17.259) and WIA Dislocated Workers (Federal Catalog Number 17.260). Additionally, EDD administers the Trade Adjustment Assistance program (Federal Catalog Number 17.245). The State reported that these programs collectively received \$25.5 billion for fiscal year 2009–10, including Recovery Act funds totaling approximately \$13.6 billion. We cannot conclusively identify Recovery Act dollars because we found that EDD has not been able to track all Recovery Act dollars separately from non-Recovery Act dollars. The State Auditor's Office identified four findings as of December 1, 2010, that pertain to EDD's administration of these federal programs. The findings relate to tracking Recovery Act funds, subrecipient monitoring, suspension and

debarment, and eligibility determinations. All four of these findings have been previously reported in our annual audits: this is the fourth year for one, the third year for two more, and the second year for the remaining one.

**The Department of Health Care Services (Health Care Services)** administers the State Medicaid Fraud Control Units program (Federal Catalog Number 93.775); the State Survey and Certification of Health Care Providers and Suppliers program (Federal Catalog Number 93.777); and the Medical Assistance Program (Federal Catalog Number 93.778), which collectively comprise the Medicaid Cluster of federal programs and is commonly referred to as Medi-Cal in California. The objective of Medi-Cal is to pay for medical assistance to low-income persons who are age 65 or over; as well as others that meet certain criteria. In fiscal year 2009–10 Health Care Services received \$28.4 billion for this program, including \$4.6 billion in Recovery Act funds. The State Auditor’s Office identified six findings as of November 19, 2010, that pertain to Health Care Services’ administration of Medi-Cal. The findings focused on a variety of issues, such as internal control deficiencies relating to the State’s practice of granting temporary Medi-Cal benefits to individuals who are “presumptively eligible” for such services. Although Health Care Services has taken steps to address some of the issues we reported in last year’s annual report, it still needs to do more to fully correct these issues. For example, in last year’s annual audit we reported that Health Care Services was not submitting drug rebate information to drug manufacturers on a timely basis, limiting the State’s ability to obtain rebates in a timely manner and earn interest on these funds. During our testing for fiscal year 2009–10, we found that Health Care Services continued to submit drug rebate information after federally prescribed deadlines. Finally, our testing revealed that Health Care Services corrected two findings from last year’s annual audit report.

**The California Department of Transportation (Caltrans)** administers the Highway Planning and Construction Cluster, which includes the Highway Planning and Construction program (Federal Catalog Number 20.205). The objectives of this program are to assist states in the planning and development of an integrated, interconnected transportation system important to interstate commerce and travel by constructing and rehabilitating the National Highway System (NHS), including interstate highways and most other public roads. Caltrans uses federal funds under this program for a variety of activities, such as making capital improvements to certain designated highways and providing subgrants to local agencies, such as cities and counties, for similar projects. During fiscal year 2009–10, Caltrans received more than \$2.6 billion, of which approximately \$589 million was provided by the Recovery Act. The State Auditor’s Office has identified three findings as of December 20, 2010, that pertain to Caltrans’ administration of this federal program. These findings discuss deficiencies in internal control and instances of noncompliance with federal requirements concerning cash management, matching, and subrecipient monitoring. For instance, we noted that Caltrans lacked adequate internal controls to ensure that local agencies had audits performed under the Single Audit Act as required by OMB Circular A-133. Our review also found that 24 local agencies receiving more than \$500,000—and in some cases receiving more than \$1 million—did not submit audit reports to the federal government for fiscal year 2008–09. We also noted that Caltrans lacked policies and procedures to impose sanctions on local agencies who fail to submit required audits. The lack of audit reports by local agencies limits Caltrans’ ability to review and issue management decisions on potential audit findings and exercise effective oversight for this federal program.

**The California Department of Veterans Affairs (Veterans Affairs)** administers the Grants to States for Construction of State Home Facilities (construction grant) and Veterans Housing—Guaranteed and Insured Loans (loan guaranty) programs (Federal Catalog numbers 64.005 and 64.114, respectively). The objectives of this construction grant program include providing financial assistance

to states to acquire or construct state veterans home facilities, while the loan guaranty program offers home loans to eligible veterans that are guaranteed in part by the U.S. Department of Veterans Affairs (VA). Through the loan guarantee program, as of June 30, 2010, the VA provided guarantees for loans held by Veterans Affairs totaling \$112.5 million. These guarantees are considered federal assistance to the State for fiscal year 2009–10. Additionally, the State reported receiving during that period \$26.6 million in federal funds for the construction grant program. Neither program received Recovery Act funds. As of December 1, 2010, the State Auditor’s Office identified one finding relating to reporting requirements that pertains to Veterans Affairs’ administration of the loan guaranty program. For example, Veterans Affairs reported to the VA several events related to veterans with delinquent loans after the applicable deadlines. In the one case we reviewed in which a borrower filed for bankruptcy, Veterans Affairs reported the filing more than eight months late. The State Auditor’s Office also identified three findings that pertain to the construction grant program, which concerned a variety of different federal regulations including those governing allowable costs, the Davis-Bacon Act, and reporting. Although Veterans Affairs has taken certain steps to address the issues we reported in last year’s annual audit related to these findings, concerns in these areas continued to exist during fiscal year 2009–10.

### **Agency Comments**

We summarized the departments’ responses. In general, the departments concurred with the audit findings discussed in this interim report and plan to take corrective action.

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## Employment Development Department

Based on the U.S. Office of Management and Budget's (OMB) June 2010 guidance, the California State Auditor's Office (State Auditor's Office) presents its interim report on the Employment Development Department's (EDD) administration of the programs listed in the text box. The State reported that these eight programs collectively received \$25.5 billion for fiscal year 2009–10, which included American Recovery and Reinvestment Act of 2009 (Recovery Act) funds totaling approximately \$13.6 billion received by five of these programs. The issues contained in this interim report represent the results of our internal control and compliance audit that require EDD's corrective action. The State Auditor's Office identified four findings as of December 1, 2010, that pertain to EDD's administration of four federal programs. These four findings include certain issues that we have disclosed in previous annual audit reports. Our testing this year also confirmed that EDD corrected two other findings that we included in last year's annual audit report.

### Name of Federal Programs Audited and Federal Catalog Number:

Unemployment Insurance (17.225)

#### Employment Service Cluster

- Employment Service/Wagner-Peyser Funded Activities (17.207)
- Disabled Veterans' Outreach Program (17.801)
- Local Veterans' Employment Representative Program (17.804)

#### Workforce Investment Act (WIA) Cluster

- WIA Adult Program (17.258)
- WIA Youth Activities (17.259)
- WIA Dislocated Workers (17.260)

Trade Adjustment Assistance (17.245)

### EDD Cannot Identify All of Its Recovery Act Expenditures

EDD's financial management systems do not allow it to separately identify and report on Recovery Act funds expended for certain benefits paid under the Unemployment Insurance (UI) program. Federal regulations state that to maximize the transparency and accountability of funds authorized under the Recovery Act, recipients agree to maintain records that identify the source and application of Recovery Act funds and to separately identify the expenditures for federal awards under the Recovery Act on the Schedule of Expenditures of Federal Awards. Further, OMB's *Circular A-133 Compliance Supplement* dated June 2010 regarding special tests and provisions for awards with Recovery Act funding, indicates that the financial management system must permit the preparation of required reports and the tracing of funds adequate to establish that funds were used for authorized purposes and allowable costs. Additionally, according to a program letter provided by the U.S. Department of Labor (Federal Labor), some unemployment benefit payments should be reported separately as Recovery Act expenditures.

EDD has not yet corrected a prior-year finding related to tracking Recovery Act funds. In our fiscal year 2008–09 audit report, we reported that EDD's financial management systems did not allow it to separately identify and report on Recovery Act funds expended for certain benefits paid under the UI program. Specifically, although EDD could identify Recovery Act expenditures for the Federal Additional Compensation (FAC) program because it was entirely funded by the Recovery Act, EDD could not separately identify Recovery Act expenditures for either the Emergency Unemployment

Compensation (EUC) program or the Federal-State Extended Benefits (Fed-Ed) program. EDD stated that it agreed with our finding and intended to update its financial management systems by March 2010. However, as of October 11, 2010, EDD had not yet updated its financial management systems to separately identify and report on Recovery Act funds.

During fiscal year 2009–10, the UI program spent \$24.8 billion, which included both Recovery Act and non-Recovery Act funds. As detailed in the text box, of the several types of unemployment benefit program components, the EUC, Fed-Ed, and FAC program components expended Recovery Act funds. The FAC program provided an additional \$25 a week to claimants, the Fed-Ed program provided up to 20 additional weeks of UI benefits to eligible claimants, and the EUC program provided up to 53 additional weeks of UI benefits to claimants. In fiscal year 2009–10 EDD spent \$13.6 billion on these programs. According to an accounting officer in the General Ledger Unit, EDD is unable to identify what portion of the total expenditures for these three program components were paid for with Recovery Act funds, including FAC because, according to a manager at EDD, FAC is no longer entirely funded by the Recovery Act.

According to an EDD division chief (chief), EDD was unable to begin separately identifying Recovery Act funds when planned due to changes in federal legislation that required high-priority modifications in programming related to benefit extensions and payments. The chief stated that if no new federal legislation passes changing benefit extensions and payments, EDD intends to have the issue fully corrected by early 2012. Specifically, EDD plans to complete work, including testing and validation, by April 2011. Producing the revised reports is expected to begin directly after that and should be completed at the end of May 2011. EDD estimates it will take between nine and 12 months to then properly recalculate and reclassify the data. Until EDD has completed the necessary program changes, it cannot maintain records that identify the source and application of Recovery Act funds or separately identify the expenditures of federal awards under the Recovery Act on the Schedule of Expenditures of Federal Awards, as required by federal regulations.

To ensure the Recovery Act funds can be separately identified for the FAC, Fed-Ed, and EUC program components, we recommend that EDD continue its efforts to update its financial management systems. In its corrective action plan, EDD stated that it will continue working on information system changes to enable separate identification of Recovery Act funds.

#### Unemployment Insurance Benefits Related to the American Recovery and Reinvestment Act of 2009 (Recovery Act)

- **Federal Additional Compensation (FAC):** Increased all benefit payments (including regular unemployment insurance) by \$25 a week, beginning February 22, 2009.
- **Emergency Unemployment Compensation (EUC):** Provides up to 53 additional weeks of unemployment benefits. The Recovery Act extended the time frame in which claimants could file for EUC and receive benefits.
- **Federal-State Extended Benefits (Fed-Ed):** Provides up to 20 additional weeks of unemployment benefits. The Recovery Act provided that such benefits are paid fully by the federal government except benefits paid to claimants whose eligibility for benefits was based on prior employment with state and local governments or federally recognized Indian Tribes.

Sources: Recovery Act, Grant Agreements, Program Letters, Compliance Supplement, Employment Development Department Web site.

## EDD Has Repeatedly Failed to Perform Required Monitoring of Subrecipients

As we reported in prior years, EDD has not monitored some WIA subrecipients. The OMB's *Circular A-133* requires that pass-through entities such as EDD monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved. Additionally, federal regulations require that the State's monitoring system provide for annual on-site monitoring reviews of local areas' compliance with Federal Labor's uniform administrative requirements.

The purpose of the WIA is to promote an increase in the employment, job retention, earnings, and occupational skills improvement by participants. EDD allots WIA funds and Recovery Act funds to both Local Workforce Investment Areas (LWIAs) and non-Local Workforce Investment Areas (non-LWIAs) for use in a range of workforce development activities. LWIAs include both cities and counties. Non-LWIAs include community-based organizations and various state entities including the California Department of Corrections and Rehabilitation and the California Community Colleges Chancellor's Office. For fiscal year 2009–10, EDD allocated more than \$369 million in WIA formula funds and \$386 million in Recovery Act funds to 49 LWIAs. EDD also allocated more than \$62 million in WIA and Recovery Act funds to 48 non-LWIAs for workforce development activities.

EDD did not monitor some WIA subrecipients. In our prior-year audit, we found that while EDD's Compliance Monitoring Section (CMS) had monitored all LWIAs, it only monitored five of the non-LWIAs. During our follow-up procedures for the fiscal year 2009–10 audit, we found that EDD has not fully corrected this finding. Specifically, although CMS again monitored all LWIAs, it monitored only 13 of the 48 non-LWIAs that received funding in fiscal year 2009–10. According to EDD, monitoring of all non-LWIAs will be completed by early 2011. Until EDD has completed the required monitoring of all non-LWIAs, EDD cannot ensure that non-LWIAs are complying with federal laws, regulations, and provisions of grant agreements.

In its response to our prior-year finding, EDD stated that the inability to complete on-site reviews of all organizations was due to staffing limitations, and that EDD would hire new staff to assist in completing the monitoring reviews. As of June 2010 EDD filled 10 new positions within the CMS using Recovery Act funds. However, according to the CMS chief (chief), EDD has not submitted a budget request to convert the positions from limited-term Recovery Act funded positions to permanent ones, and will continue to evaluate the need for extended staffing over the next months and take appropriate action if a need materializes.

In order to comply with federal regulations, we recommend that EDD's CMS continue to work toward monitoring all WIA recipients to ensure that federal funds are used for authorized purposes. According to EDD's corrective action plan, EDD's CMS continues its efforts to monitor all WIA recipients to ensure that federal funds are used for authorized purposes. EDD reports that it successfully completed 63 non-LWIA monitoring reviews originally scheduled through December 2010. According to the chief, this includes non-LWIAs receiving funding prior to fiscal year 2009–10. EDD believes it has fully addressed this finding.

## **EDD Is Not Effectively Implementing Its Procedures to Comply With Federal Suspension and Debarment Requirements for the Employment Service Cluster**

Although it adopted procedures to ensure that it is verifying contractors' suspension and debarment status for the Employment Service Cluster, EDD has not effectively implemented those procedures. Federal regulations state that, before entering into a covered transaction, the contracting entity must verify that the person with whom it intends to do business is not excluded or disqualified from participating in a federal program. A "covered transaction" is a contract for goods or services, awarded in a non-procurement transaction, that is expected to equal or exceed \$25,000. The contracting entity may ensure that the person with whom it intends to do business is not excluded or disqualified by checking the Excluded Parties List System (EPLS) or collecting a certification from the person.

In our fiscal year 2007–08 audit, we reported that EDD did not have adequate policies or procedures in place to comply with federal suspension and debarment requirements. Although EDD ensured that service contracts over \$25,000 included a suspension and debarment certification, it did not obtain such a certification for the purchase of goods over \$25,000. Additionally, EDD did not check the EPLS to verify that entities it purchases goods from were not suspended or debarred. By not obtaining suspension and debarment certifications or performing an independent check on the EPLS, EDD ran the risk of entering into a covered transaction with a party that is excluded from doing business with the federal government. In order to correct this finding, we recommended that EDD establish policies and procedures to ensure that it is performing the required verifications for suspension and debarment for contracts and purchases of goods with a value equal to or more than \$25,000.

During our follow-up procedures for fiscal year 2008–09, we noted that EDD had not fully corrected the finding. Specifically, although EDD implemented the recommended policies and procedures to address suspension and debarment, it did not do so until April 2009. As a result, EDD did not have adequate policies and procedures in place for the majority of fiscal year 2008–09.

During our follow-up procedures for fiscal year 2009–10, we found that although EDD's procedures related to suspension and debarment were in place for the entirety of fiscal year 2009–10, EDD did not fully implement those procedures. Specifically, EDD's updated desk procedures require that every contract for goods purchased over \$25,000 have either a suspension and debarment certificate included in the file or an EPLS printout verifying that the proposed vendor is not excluded or disqualified. Also, according to a procurement section chief, for any service contract over \$5,000 a signed debarment certificate must be obtained. However, for one of the 12 contracts we reviewed, EDD checked the vendor against the EPLS on September 23, 2010, even though the contract was awarded in April 2010. According to EDD's procurement chief, this was a "leveraged procurement" and EDD is not required to check the EPLS if there is a certification in the Department of General Services' (DGS) file. However, according to an EDD procurement section chief, there was no such certification in the DGS contract file. Therefore, we cannot conclude that EDD effectively implemented its procedure to verify that a vendor is not suspended or debarred by consulting the EPLS.

In order to comply with federal regulations, EDD should ensure that the official procurement files include documentation, which demonstrates that EDD is following its adopted procedures. According to EDD's corrective action plan, to assist EDD procurement staff with their roles in the procurement process and to ensure every procurement file contains required documents, a Procurement Checklist (checklist) is being developed and will be provided to each procurement analyst and manager within 30 days. The checklist provides detailed information on what documents are to be included in the file. Analysts will be required to complete the checklist upon the completion of each procurement and

the checklist must be included in the file. Additionally, to ensure every procurement file contains the required documents, the EDD Procurement Section has adopted a review and approval process to verify the contents of the procurement file. EDD stated that these changes will result in eliminating procurement files that are out of compliance.

### **EDD Did Not Complete Monitoring of Trade Adjustment Assistance Eligibility Determinations During Fiscal Year 2009–10**

EDD adopted procedures for monitoring its field offices' determinations of eligibility for training under the Trade Adjustment Assistance (TAA) program, but had not fully implemented those procedures until after fiscal year 2009–10. Federal regulations outline six criteria for determining whether an adversely affected worker is eligible for training. According to the regulations, training shall be approved if there is no suitable employment available for the worker, the worker would benefit from the training, there is a reasonable expectation of employment following the training, the training is available, the worker is qualified to undertake and complete the training, and the training is suitable for the worker and available at a reasonable cost. Additionally, a 2006 report by Federal Labor recommended that the State Trade Act Coordinator (coordinator) conduct on-site monitoring and randomly select files to review.

In our fiscal year 2006–07 audit report, we reported that EDD lacked adequate controls to ensure that its field offices made appropriate eligibility determinations for the TAA program. We noted that EDD's field offices lacked the information necessary to determine how to document the six conditions of training eligibility on the TAA Training Plan, DE-8751 (TAA training plan). Additionally, we reported that the coordinator conducted quarterly desk reviews of files sent by field offices rather than the site reviews recommended by Federal Labor.

During our follow-up procedures for fiscal year 2007–08, we reported that EDD made policy and procedure changes, but did not implement those changes during fiscal year 2007–08. EDD stated it revised and published the TAA training plan in October 2008 and that the training plan would serve as a control document. Additionally, EDD stated it had procedures in place to randomly monitor TAA document files on a quarterly basis and that the Workforce Services Branch was coordinating with the Compliance and Review Division to develop on-site document monitoring during one quarter of every year.

In our prior-year audit, we found that EDD revised its TAA training plan in September 2008 and developed new TAA monitoring guidelines in July 2009. However, because the revised TAA training plan and the TAA monitoring guidelines were not in place for the full fiscal year 2008–09, we were unable to determine whether this audit finding had been fully corrected.

During our follow-up procedures for fiscal year 2009–10, we found that while EDD had policies and procedures in place for the entire 2009–10 fiscal year, it only recently implemented them. Specifically, according to an analyst at EDD, the first desk review conducted using the procedures for random selection was not complete until May 2010. Further, although the desk review examined records for the second quarter of fiscal year 2009–10, the first on-site monitoring report covered the period from July 2010 through September 2010. Thus, part of the monitoring occurred after the end of fiscal year 2009–10. Because EDD had not completed full implementation of its policies and procedures until after our period of review, this finding remains uncorrected for fiscal year 2009–10.

In order to comply with federal requirements, we recommend that EDD continue to implement its monitoring procedures. According to EDD, it is now fully complying with the TAA program's monitoring requirements. In its corrective action plan, EDD states that it is now completing the monitoring desk review for the fourth quarter of federal fiscal year 2009–10 and that it completed the required on-site review in the fourth quarter of federal fiscal year 2009–10, consistent with federal requirements that this review be completed by the end of the federal fiscal year.

### EDD Took Steps to Correct Two Findings Reported for Fiscal Year 2008–09

During our current audit, we determined that EDD had fully corrected two of six findings we reported for fiscal year 2008–09. As shown in Table 1 below, these two findings applied to the TAA program. We confirmed that EDD had corrected these findings during the 2009–10 fiscal year. The table presents a listing of the corrected findings and a reference to the finding description as it was reported in the State Auditor's Office annual report titled *State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009* (report number 2009-002, dated March 2010). In addition, the table indicates whether the State received Recovery Act funds for the federal programs listed.

**Table 1**  
**Findings Reported for Fiscal Year 2008–09 That the Employment Development Department Has Corrected**

FEDERAL PROGRAM TITLE	FEDERAL CATALOG NUMBER	CATEGORY OF FINDING	REPORT 2009-002, ISSUED MARCH 2010: REFERENCE NUMBER/PAGE NUMBER	RECEIVED RECOVERY ACT FUNDS DURING FISCAL YEAR	
				2008–09	2009–10
Trade Adjustment Assistance	17.245	Reporting	2009-12-3/203	No	No
Trade Adjustment Assistance	17.245	Reporting	2009-12-4/204	No	No

Source: California State Auditor's Office analysis of corrective action on the Employment Development Department's findings.

## Department of Health Care Services

Based on the U.S. Office of Management and Budget's (OMB) June 2010 guidance, the California State Auditor's Office (State Auditor's Office) presents its interim report concerning the Department of Health Care Services' (Health Care Services) administration of the Medicaid Cluster of federal programs, as listed in the text box, for fiscal year 2009–10. The Medicaid Cluster is commonly referred to as Medi-Cal in California. The State received \$28.4 billion in federal funds during this period, of which \$4.6 billion was received under the American Recovery and Reinvestment Act of 2009 (Recovery Act).

### Name of Federal Programs Audited and Federal Catalog Number:

#### Medicaid Cluster:

- State Medicaid Fraud Control Units (93.775)
- State Survey and Certification of Health Care Providers and Suppliers (93.777)
- Medical Assistance Program (93.778)

The issues contained in this interim report represent the interim results of our internal control and compliance audit that require Health Care Services' corrective action. The State Auditor's Office identified six findings as of November 19, 2010, that pertain to Health Care Services' administration of Medi-Cal. Of these six findings, four are repeat findings we have disclosed in previous annual audit reports. Our testing this year also revealed that Health Care Services corrected two other findings we included in last year's annual audit report.

### Health Care Services Does Not Adequately Track Information Related to Presumptive Eligibility

Pregnant women, who are California residents without health insurance for prenatal care, can access Medi-Cal benefits on a temporary basis upon a medical provider's determination that the patient is presumptively eligible for Medi-Cal. Since presumptively-eligible women access Medi-Cal benefits before their eligibility is formally determined, these women are not entered into Health Care Services' eligibility systems. Instead, medical providers assign prenumbered Medi-Cal identification cards—which providers obtain from Health Care Services—to presumptively eligible women. When submitting claims for payment under Medi-Cal, medical providers use the information on the prenumbered identification cards to identify the patient served when requesting reimbursement.

Under the State's plan for Medi-Cal, medical providers are required to submit to Health Care Services a weekly enrollment summary of all presumptively eligible identification numbers issued. Health Care Services is required to maintain this documentation for three years. However, since the State's fiscal intermediary, Hewlett-Packard, is responsible for processing Medi-Cal payments and lacks information on presumptively eligible identification numbers maintained by Health Care Services, Hewlett-Packard does not perform eligibility audit procedures over expenditure claims pertaining to beneficiaries who are presumed eligible for Medi-Cal. Instead, Hewlett-Packard has set its payment processing system to bypass an eligibility check of a Medi-Cal beneficiary if the system recognizes the presumptive eligibility identification number.

Consistent with the finding we reported for the previous fiscal year, Health Care Services does not reconcile the presumptive eligibility numbers shown on the expenditure claims processed by Hewlett-Packard with the summary enrollment listings submitted by medical providers. As a result, Health Care Services does not know whether Medi-Cal payments being made for presumptively

eligible women are for women actually enrolled by medical providers. Further, Health Care Services is at risk of making duplicate payments for women who may have been issued multiple identification numbers.

We recommend that Health Care Services strengthen its internal controls process to obtain and track the presumptive eligibility identification numbers issued to prevent their unauthorized use. Further, we recommended that it perform procedures to authenticate the existence of the beneficiary and reconcile identification numbers shown on claims for payment with the summary enrollment listings submitted by medical providers. In its response, Health Care Services indicated that it lacked the necessary resources to develop and implement automated systems to address this finding. However, Health Care Services believes the Patient Protection and Affordable Care Act (PPACA) of 2010 provides an opportunity to implement a solution to this problem. As California moves towards creating a Health Benefits Exchange, a component of this exchange will be the ability to screen for and enroll eligible individuals into the Medi-Cal program, utilizing a web-based enrollment portal. Health Care Services explained that the Health Benefits Exchange will provide an opportunity to allow presumptive eligibility qualified providers to complete enrollment for eligible pregnant women using an internet-based application that will provide real-time validation with the Statewide Medi-Cal Eligibility Data System. In the meantime, Health Care Services indicated that it is awaiting further guidance from CMS and is analyzing the Medicaid provisions of PPACA.

### **Health Care Services Does Not Provide Drug Rebate Information to Drug Manufacturers Within the Required Time Frame**

Federal regulations require Health Care Services to report to each drug manufacturer, no later than 60 days after the end of each rebate period, information on outpatient drugs for which payments were made during the period.

The drug rebate process begins when drug manufacturers provide a listing to CMS of all covered outpatient drugs and, on a quarterly basis, are required to provide their average manufacturer's price and their best prices for each covered outpatient drug. Based upon this data, CMS calculates the rebate amount for each drug and provides this rebate information to the states. In California, Health Care Services is required to send the drug utilization data to manufacturers no later than 60 days after the end of the quarter. Once the utilization data is received, drug manufacturers have 30 days to pay the State the required rebate or dispute the claim.

Health Care Services was late in providing drug manufacturers with utilization data for drugs dispensed to Medi-Cal patients. We tested 40 rebate invoices related to the third and fourth quarters of 2009 and the first and second quarters of 2010, and noted that Health Care Services did not provide the drug manufacturers with utilization data until between three and 12 days after the 60-day deadline. As a result, the State and federal government did not obtain the rebates it was due in a timely manner and potentially missed an opportunity to earn interest on these funds. This is a repeat finding first identified in our annual audit report for fiscal year 2006–07. For context, the combined federal and state drug rebates for the first two quarters of fiscal year 2009–10 (July 2009 through December 2009) amounted to more than \$495 million.

We recommend that Health Care Services take steps to ensure that drug utilization data are promptly provided to drug manufacturers and to proactively monitor the receipt of rebate payments. Health Care Services indicated that it has modified the Rebate Accounting Information System (RAIS) to

allow the invoicing process to be more efficient and require less manual review, thus allowing for the timely mailing of data to drug manufacturers. Health Care Services also indicated that employee furloughs and delays in getting necessary rebate information from CMS contributed to the late submissions of drug utilization data.

### **Health Care Services Does Not Ensure That All Provider Claim Forms are Retained**

Federal law requires Health Care Services to ensure provider claim forms contain specific statements certifying as to the accuracy and completeness of the information they contain and include the claimant's signature.

Health Care Services and its contractor, the Department of Social Services (Social Services), lack controls to ensure claim forms submitted for reimbursement for Medi-Cal's Personal Care Services Program (PCSP) are retained. The PCSP is part of the In-Home Supportive Services Program administered by Social Services. PCSP services are federally reimbursed in part through the Medi-Cal program. Health Care Services reviews all invoices submitted by Social Services for reimbursement and verifies the appropriateness of the costs incurred. The recipient and provider complete, sign, and submit semi-monthly claims in the form of timesheets to the county, which lists the number of hours worked by the provider in performing services for the care of the recipient.

Of the 25 claim forms selected for review, one provider claim form could not be located. This was a timesheet that related to activity in Sacramento County for the month of September 2009. The sampled 25 claim forms represented \$10,315 in Medi-Cal (non-Recovery Act) costs. The missing claim form represents \$180 in questioned costs for non-Recovery Act expenditures, or 1.7 percent of the expenses tested. During fiscal year 2009–10, Medi-Cal (non-Recovery Act) payments to Social Services amounted to \$3.1 billion. If the error rate of 1.7 percent was applied to all \$3.1 billion, it would result in potentially questionable costs of \$52.7 million. During fiscal year 2009–10, total Medi-Cal Recovery Act payments for the PCSP were \$605 million. If the 1.7 percent was applied to all \$605 million, it would result in potentially questionable costs of \$10.2 million.

We recommend that Health Care Services and Social Services enhance their internal controls related to the PCSP to ensure claim forms are properly obtained and stored. Social Services indicated that it has moved forward with a Case Management Information and Payroll System to enhance controls and ensure claim forms are properly obtained and stored.

### **Health Care Services Does Not Ensure That Providers Retain Documentation That Would Show Compliance With Federal Requirements**

Federal regulations require Health Care Services to enter into agreements with providers furnishing services under the State's plan, in which the provider agrees to maintain certain documentation. This documentation includes any records necessary to disclose the extent of services provided to recipients and any information regarding payments claimed by the providers furnishing such services.

The determination of whether a medical provider can be approved under the Medi-Cal program is a split responsibility between Health Care Services' Provider Enrollment Division (PED) and the Department of Public Health's (Public Health) Licensing and Certification (L&C) program. PED enrolls nonfacility providers, such as doctors, pharmacies, and medical groups. L&C is responsible for determining the eligibility of facility providers, such as hospitals and long-term care facilities.

We selected a sample of both facility and nonfacility providers and requested copies of the provider agreements and required disclosure statements from PED and L&C. We noted that four of the 50 providers sampled did not have federally required provider agreements. Three of the four were medical facilities. The other was a medical provider who, in addition to lacking a provider agreement, also lacked documentation of an active license, application, and required disclosure statement.

The sample of 50 facility and nonfacility providers was identified through a sample of \$46,509 in federal (non-Recovery Act) Medicaid expenditures for fee-for-service claims. The four exceptions related to \$6,797 out of the \$46,509 in expenditures sampled, or roughly 14.6 percent. During fiscal year 2009–10, total federal Medicaid expenditures for fee-for-service claims amounted to \$9.7 billion. Therefore, if this rate was applied to the \$9.7 billion, it would result in a potential total of \$1.4 billion in payments that, in theory, could have gone to providers lacking required documentation. Total Medi-Cal Recovery Act questioned costs for the four exceptions noted amounted to \$1,576. During fiscal year 2009–10, total Medi-Cal Recovery Act expenditures for fee-for-service claims amounted to \$2 billion. Therefore, if the rate was applied to the \$2 billion, it would result in a potential total of \$292 million in Recovery Act payments that, in theory could have gone to providers lacking required documentation.

We recommend that Health Care Services and Public Health strengthen their respective internal controls to retain all provider agreements and obtain necessary documentation. Health Care Services agreed with the recommendation to strengthen its internal controls. In regards to the one provider that lacked evidence of an active license and other documents, Health Care Services indicated that the provider had been enrolled in the Medi-Cal program since 1978 and that most likely the records were misplaced when PED implemented its tracking database. Health Care Services also indicated that as of June 2010, provider agreements for the three facility providers had been obtained from Public Health.

### **Health Care Services Did Not Perform Enough Site Visits of Local Government Agencies Based on Its Agreement With CMS**

Health Care Services' Medi-Cal Administrative Activities (CMAA) unit is required to monitor Local Government Agencies (LGAs) that receive federal funding for the reimbursement of expenditures for Medi-Cal services and administration costs. This monitoring process is conducted through county site visits. The CMAA unit has an internal policy that requires every LGA to be visited once every four years from the date of the previous visit. The CMAA unit's internal policy is guided by an agreement between CMS and the CMAA unit.

In July 2009 Health Care Services imposed travel restrictions on its employees. As a result, the CMAA unit only conducted one site visit at Alameda County. However, 22 LGA site visits should have been performed since the previous visits for these LGAs took place more than four years ago. Total federal expenditures made to the LGAs during fiscal year 2009–10 exceeded \$266.1 million.

We recommend that Health Care Services ensure that they perform the necessary site visits of its LGAs. In response, Health Care Services agreed with the recommendation and indicated that the travel restrictions were removed in fiscal year 2010–11. As a result, Health Care Services indicated that site visits resumed in November 2010. The CMAA unit expects to be in full compliance with the site visit monitoring requirement by June 30, 2012.

### Health Care Services Did Not Resolve Grievance Cases Within 90 Days as Required Under Federal Regulations

Health Care Services' Managed Care Office (MCO) is required to establish a system in which beneficiaries may report grievances. These grievances, which primarily come in the form of requests for state hearings, must be resolved by the MCO within 90 days of the reported grievance or request for a hearing date. The MCO may extend the 90-day time frame by 14 calendar days if the beneficiary requests an extension, or if the MCO can show that there is a need for additional information. The MCO must also demonstrate how the delay is in the beneficiary's interest. In our sample of 25 state hearing cases, five did not appear to be scheduled or resolved within 90 days of the initial enrollee request date. The delays noted in these five cases ranged between six days and 42 days beyond the 90-day deadline. Our review of these files did not note any beneficiary requests for a 14-day extension, nor did we see any evidence that the MCO requested an extension showing there was a need for additional information.

We recommend that Health Care Services strengthen its internal controls to ensure that hearings are scheduled on a timely basis. Health Care Services indicated that it agreed with the recommendation. Health Care Services explained that it had delegated the scheduling of the state hearings to Social Services. However, Health Care Services indicated that effective November 2010 it would require Social Services to explain any hearing requests approaching 60 days from the date of receipt and to provide updates on any extension requests or postponements.

### Health Care Services Took Steps to Correct Two Findings Reported for Fiscal Year 2008–09

During the current audit, we determined that Health Care Services had fully corrected two of the nine findings we reported for fiscal year 2008–09. Table 2 presents a listing of the corrected findings and a reference to the finding description as it was reported in the State Auditor's Office annual report titled *State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009* (report number 2009-002, dated March 2010).

**Table 2**  
Findings Reported for Fiscal Year 2008–09 That the Department of Health Care Services Has Corrected

FEDERAL PROGRAM TITLE	FEDERAL CATALOG NUMBER	CATEGORY OF FINDING	REPORT 2009-002, ISSUED MARCH 2010: REFERENCE NUMBER/PAGE NUMBER	RECEIVED RECOVERY ACT FUNDS DURING FISCAL YEAR	
				2008-09	2009-10
Medical Assistance Program	93.778	Reporting	2009-12-16/page 252	Yes	Yes
Medical Assistance Program	93.778	Subrecipient Monitoring	2009-13-19/page 253	Yes	Yes

Source: California State Auditor's Office analysis of corrective action on the Department of Health Care Services' findings.

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# California Department of Transportation

## HIGHWAY PLANNING AND CONSTRUCTION CLUSTER

### HIGHWAY PLANNING AND CONSTRUCTION FEDERAL CATALOG NUMBER 20.205

Based on the U.S. Office of Management and Budget's (OMB) June 2010 guidance, the California State Auditor's Office (State Auditor's Office) presents its interim report concerning the California Department of Transportation's (Caltrans) administration of the Highway Planning and Construction Cluster, which includes the Highway Planning and Construction program (Federal Catalog Number 20.205). The State received \$2.6 billion for the cluster during fiscal year 2009–10, including American Recovery and Reinvestment Act of 2009 (Recovery Act) funds of \$589 million.

The issues contained in this interim report represent the results of our internal control and compliance audit that require Caltrans' corrective action. The State Auditor's Office identified three findings as of December 20, 2010, that pertain to Caltrans' administration of this federal program. Our testing this year also revealed that Caltrans corrected the two findings that we had included in last year's annual audit report.

#### **Caltrans Did Not Always Follow the Federally Approved Funding Technique Negotiated in the Treasury-State Agreement and Should Review Its Methodology for Calculating Interest Liability**

During fiscal year 2009–10, Caltrans lacked adequate internal controls to ensure that it consistently adhered to the funding techniques specified in the Treasury-State Agreement (TSA) for the Highway Planning and Construction program (highway program). Under the terms of the TSA, the federal government and the State agreed that roughly 90 percent of highway program funds would be requested by Caltrans under the "pre-issuance" funding technique, where Caltrans would request federal funds such that they are deposited in a state account not more than three business days before making a disbursement. Under the terms of the TSA, this 90 percent component of the program includes payments for construction contracts, right-of-way acquisitions, and consultant contracts and subventions (such as grants to local governments). The TSA defined the remaining 10 percent of federal receipts as reimbursements for payments already made by the State for various miscellaneous costs and specified that an interest liability did not apply to these funds.

Of the \$2.6 billion in federal funds Caltrans received during fiscal year 2009–10, Caltrans indicated that \$358.3 million (approximately 14 percent of total federal receipts) represented expenditures from prior years for advanced construction payments and other expenses previously paid by the State. However, the TSA requires that construction payments be made under pre-issuance not reimbursement. We noted that some of these payments advanced by the State were processed several years ago. For example, \$453,000 of the \$358.3 million was for payments processed during 2002 and \$9.8 million was from 2003.

Caltrans also did not follow the correct funding technique for \$34 million in program expenditures processed during fiscal year 2009–10. During our review of Caltrans' interest liability calculation, we determined that Caltrans had excluded \$34 million in expenditures that were subject to the pre-issuance funding technique because Caltrans determined that federal funds were received after the State had made payment. Specifically, Caltrans explained that federal funds were received after the

period of average clearance (i.e. the average amount of time it takes for checks or warrants to be cashed) had lapsed. As a result, Caltrans considered the \$34 million in payments from the federal government to be a reimbursement for costs already paid by the State.

The TSA requires that the State must notify the U.S. Department of Treasury, Financial Management Service (FMS), within 30 days of the time it becomes aware of changes in funding techniques, and must include a proposed amendment to FMS. However, we noted that the fiscal year 2009–10 TSA was not amended to reflect any changes in the funding techniques or how Caltrans was actually drawing down federal funds for the program.

Although Caltrans appropriately did not calculate and assess the federal government any interest liability on these advanced state funds, the State and the federal government mutually agreed to the terms of the fiscal year 2009–10 TSA and the appropriate funding techniques to be used for the program. When the State does not update the TSA to reflect how federal funds are actually being requested, the State prevents the federal government from having input on how to most effectively and efficiently transfer its own funds to the State. The cause of this finding appears to be Caltrans' decision to modify its funding techniques from fiscal years 2008–09 to 2009–10. Caltrans elected in fiscal year 2009–10 to have most of its funds requested on a pre-issuance basis in order to ensure it could request funds earlier and have money available to quickly pay costs associated with the Recovery Act. However, the pre-issuance funding technique does not accurately reflect how federal funds are drawn for certain program costs.

We also noted an inconsistency regarding how Caltrans calculates how long it holds onto federal funds when preparing its interest calculation. Section 8.6.5 of the TSA requires the State to separately measure two distinct time periods as part of the interest calculation process. The two time periods are as follows:

- The time between when federal funds are deposited in a state account and when warrants are issued.
- The time between the issuance of warrants to redemption (i.e. when the funds leave the State's account).

Caltrans estimated both of these time periods by sampling expenditures where the checks or warrants were issued in 2007 (with a few warrants issued during January 2008). Caltrans then provided this information to the Department of Finance (Finance). However, such a sampling methodology using 2007 data for determining the time between the receipt and disbursement of federal funds is questionable. Section 8.6.4 of the TSA requires the State to measure the time between the receipt of federal funds and the issuance of warrants from information collected by state departments. Although Section 8.6.4 does not explicitly specify the time period to be used for this calculation, we believe using fiscal year 2009–10 data for this period would have been more appropriate based on the following:

- The Department of Finance collects current-year information from other state departments administering federal programs.
- The TSA discusses how the State will calculate the interest liability for fiscal year 2009–10, suggesting that Caltrans should have considered this same time period when determining how long it held federal funds prior to disbursing program funds.

We did not question Caltrans' decision to use 2007 data to measure the time between the issuance of warrants to redemption because the TSA for fiscal year 2009–10 does not require the State to maintain a clearance pattern for this program.

We recommend that Caltrans coordinate with Finance to ensure the TSA accurately reflects the funding techniques Caltrans follows when administering the highway program. We also recommend that Caltrans develop policies and procedures to ensure that it adheres to such funding techniques. Finally, we recommend that Caltrans use more current information when calculating the interest liability, or work with Finance to ensure the TSA is modified to reflect Caltrans' current practice. In response to our finding, Caltrans indicated that it would contact Finance by January 31, 2011, to modify the TSA. Specifically, Caltrans intends to make the TSA more explicit about the funding techniques to be used and the calculation of clearance patterns.

### **Caltrans Lacks Internal Controls to Prevent or Detect Noncompliance With Matching Requirements**

Although we found that Caltrans complied with the matching requirement during fiscal year 2009–10, it lacked adequate internal controls to ensure that noncompliance with the matching requirement would be prevented or detected in a timely manner.

Caltrans uses state funds when making payments under the highway program, disbursing funds from its Transportation Revolving Account. Caltrans also submits claims to the federal government for its share of the payments. The difference between what the State initially paid and the amount provided by the federal government represents the State's match on a payment.

Caltrans records program expenditures and schedules the issuance of warrants through its Transportation Accounting Management System (TRAMS). Caltrans uses a separate system called the Current Billing and Reporting System (CBARS) to identify expenditures in TRAMS that are eligible for federal reimbursement. The amount that CBARS will claim for particular TRAMS expenditures is dependent on Caltrans' staff manually entering the correct federal reimbursement percentage in the CBARS system for federally funded projects. Caltrans' procedures require its staff to identify the federally approved reimbursement rate for each project based on information contained in the Federal Highway Administration's Fiscal Management Information System (FMIS). FMIS is the official electronic agreement between the federal government and Caltrans regarding the total obligated amount for a project and the federal government's share of the costs.

During fiscal year 2009–10, Caltrans lacked procedures to ensure that its staff entered the correct federal reimbursement rates into CBARS. We had expected to see that Caltrans' management periodically reviewed these entries; however, the branch chief of Caltrans' accounting division (branch chief) explained that reviewing such entries would be an inefficient use of staff resources. According to the branch chief, Caltrans does not have managerial oversight of this data entry because the history of erroneous entries is low, and management does not believe it is cost-efficient to have a second person checking manual entries for such low-risks tasks. Additionally, the branch chief explained that Caltrans has a final vouchering process where it verifies, at the end of the project, the accuracy of reimbursement rates and makes any necessary adjustments at that time. However, Caltrans has also indicated that some of its projects can typically last anywhere from several months to several years, and in some cases can last more than a decade. As a result, relying on the final vouchering process would not, in our judgment, allow Caltrans to prevent or detect noncompliance with the matching requirement on a timely basis.

We recommend that Caltrans develop policies and procedures to provide reasonable assurance that it can detect and prevent inaccurate data entry of federal reimbursement rates in its CBARS. In response, Caltrans reiterated its contention that this data entry is a low-risk activity. Nevertheless, Caltrans stated that it would consult with the Federal Highway Administration in consideration of a periodic sampling of data, which will be reviewed by a supervisor, to ensure that the reimbursement rates are entered into the system correctly by January 31, 2011.

### **Caltrans Did Not Ensure That Subrecipients Submitted Required Audit Reports and Lacked Procedures to Impose Sanctions**

During fiscal year 2009–10, Caltrans lacked internal controls to ensure subrecipients who spent more than \$500,000 during fiscal year 2008–09 submitted audit reports to the federal government as required under OMB Circular A-133. Based on Caltrans' records of the amounts it disbursed to subrecipients, it could have established reasonable expectations as to which subrecipients would need to submit audit reports. However, we noted instances of noncompliance where subrecipients receiving more than \$500,000—and in some cases receiving more than \$1 million according to Caltrans' records—did not submit audit reports to the federal government. On October 20, 2010, we identified 24 subrecipients (including various cities, counties, and special districts) that had no record of an audit submission on the federal audit clearinghouse's Web site for fiscal year 2008–09. Subrecipients with a fiscal year ending on June 30, 2009, were required to submit their audit reports to the federal government nine months after the end of the fiscal year, which is March 31, 2010. When subrecipients fail to submit audit reports to the federal government, federal agencies miss an opportunity to identify where federal funds are being misspent. When we asked Caltrans' staff why they did not take steps to ensure subrecipients submitted their audit reports to the federal government, Caltrans' Chief of External Audits and Investigations indicated that Caltrans had believed this was the responsibility of the State Controller's Office (SCO). However, after we brought this matter to Caltrans' attention, it drafted new policies and procedures that will require its audit staff to perform a monthly reconciliation between audit submissions on the federal clearinghouse's Web site and its own records of subrecipients that received more than \$500,000.

The lack of audit reports by the subrecipients previously described also limits Caltrans' ability to review and issue management decisions on potential findings and exercise effective oversight of the Highway Planning and Construction program. To facilitate the State's preparation of management decisions on its subrecipients' audit findings, the State has established a process whereby local governments submit copies of their OMB Circular A-133 audit reports to the SCO. According to the *State Administrative Manual*, Section 20070, the SCO distributes a copy of each audit report and corrective action plan to state entities (such as Caltrans) that are affected by the findings, and such state entities follow up on audit findings pertaining to the federal programs they administer. To assist the SCO with its responsibilities, Caltrans provides the SCO with an annual listing of all of its subrecipients and the amounts they received. Caltrans provided the SCO with this information on June 3, 2010. As the SCO received audit reports from subrecipients, it provided updates on which subrecipients had or had not submitted their audit reports. As of October 15, 2010, the SCO's Web site indicated the following information for some of Caltrans' subrecipients:

- Five subrecipients had either submitted incomplete audit reports, or had not submitted any audit reports, and the SCO was no longer going to follow up with those entities.

- Sixteen subrecipients were classified by the SCO as “exempt” from the audit requirements because they spent less than \$500,000.
- Two subrecipients were classified by the SCO as “no review” because SCO concluded after reviewing the audit reports that no funds had passed through state entities (such as Caltrans).

Even though the SCO’s data—identifying certain subrecipients as having an “exempt” and “no review” status—was in conflict with Caltrans’ own records of how much it had disbursed to these subrecipients, Caltrans did not verify that the information SCO reported was correct, believing it was not its responsibility to validate the SCO’s data. Nevertheless, Caltrans has recently developed policies and procedures requiring its audit staff to reconcile its subrecipient data against the SCO’s records on a monthly basis.

During the audit for fiscal year 2009–10, we also noted that Caltrans lacked internal controls to impose sanctions on subrecipients that failed to meet OMB Circular A-133 audit requirements. According to Caltrans’ Chief of External Audits and Investigations, imposing sanctions on subrecipients is the responsibility of the Planning and Modal Programs unit. However, the Chief of External Audits and Investigations acknowledged that Caltrans’ audit unit lacked policies and procedures to notify the Planning and Modal Programs unit that required audits were delinquent and sanctions should take place. According to Caltrans’ Chief of Policy Development and Quality, Caltrans has recently developed draft procedures that are under review. In November 2010 Caltrans provided us with copies of sanction letters it sent to subrecipients with delinquent audits, informing them that Caltrans was suspending new federal awards until the SCO is satisfied that the Single Audit requirements have been met.

We recommend that Caltrans continue to implement policies and procedures to ensure that subrecipients promptly submit required audit reports and impose sanctions on those that do not. In response to the finding, Caltrans indicated that it concurred and had drafted new policies and procedures to ensure that such oversight takes place.

### Caltrans Took Steps to Correct Two Findings Reported for Fiscal Year 2008–09

During the current audit, we determined that Caltrans had fully corrected both findings we reported for fiscal year 2008–09. Table 3 presents a listing of the corrected findings and a reference to the finding description as it was reported in the State Auditor’s Office annual report titled *State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009* (report number 2009-002, dated March 2010).

**Table 3**  
**Findings Reported for Fiscal Year 2008–09 That the California Department of Transportation Has Corrected**

FEDERAL PROGRAM TITLE	FEDERAL CATALOG NUMBER	CATEGORY OF FINDING	REPORT 2009-002, ISSUED MARCH 2010:	RECEIVED RECOVERY ACT FUNDS DURING FISCAL YEAR	
			REFERENCE NUMBER/ PAGE NUMBER	2008–09	2009–10
Highway Planning and Construction	20.205	Activities Allowed / Allowable Costs; Subrecipient Monitoring	2009-1-9/page 211	Yes	Yes
Highway Planning and Construction	20.205	Subrecipient Monitoring	2009-13-12/page 212	Yes	Yes

Source: California State Auditor’s Office analysis of corrective action on the California Department of Transportation’s findings.

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## California Department of Veterans Affairs

### GRANTS TO STATES FOR CONSTRUCTION OF STATE HOME FACILITIES FEDERAL CATALOG NUMBER 64.005

### VETERANS HOUSING—GUARANTEED AND INSURED LOANS FEDERAL CATALOG NUMBER 64.114

Based on the U.S. Office of Management and Budget's (OMB) June 2010 guidance, the California State Auditor's Office (State Auditor's Office) presents its interim report concerning the California Department of Veterans Affairs' (Veterans Affairs) administration of the Grants to States for Construction of State Home Facilities (construction grant) and Veterans Housing—Guaranteed and Insured Loans (loan guaranty) programs during fiscal year 2009–10. Through the loan guaranty program, as of June 30, 2010, the U.S. Department of Veterans Affairs (VA) guaranteed \$112.5 million of the \$451.8 million in loans held by Veterans Affairs. These guarantees are considered federal assistance to the State for fiscal year 2009–10. Additionally, during that period the State reported receiving \$26.6 million in federal funds for the construction grant program. Veterans Affairs did not receive any funds from the American Recovery and Reinvestment Act of 2009 for either program.

The issues contained in this report represent the interim results of our internal control and compliance audit that require Veterans Affairs' corrective action. As of December 1, 2010, the State Auditor's Office identified one finding that pertains to Veterans Affairs' administration of the loan guaranty program and three findings that pertain to the construction grant program. Our four findings include certain issues that we disclosed in our fiscal year 2008–09 audit report.

#### **Veterans Affairs Reported Certain Loan Events After Federal Deadlines for the Loan Guaranty Program**

Veterans Affairs, as part of its administration of the loan guaranty program, is approved by the VA to offer VA-guaranteed home loans to eligible veterans. Since November 2008 the VA requires loan servicers, such as Veterans Affairs, to electronically report to the VA specific events related to loans that have been issued a VA guaranty. Federal regulations require that events be reported to the VA within the first seven calendar days of the following month, or in certain instances, within seven days of the event itself. Late reporting may hinder the VA's ability to take appropriate oversight action on delinquent loans. For selected reporting requirements, we reviewed a sample of 25 loans that were delinquent in fiscal year 2009–10 and found that Veterans Affairs did not always report the required events to the VA within the applicable reporting deadlines. We noted the following instances of late reporting or, in one case, lack of reporting:

- For the one loan in our sample where the borrower filed for bankruptcy, Veterans Affairs reported the event more than eight months late.
- For three of the 22 instances in which a loss mitigation letter was required, Veterans Affairs was seven to 60 days late in reporting that it sent the letters. Loss mitigation letters explain the seriousness of the delinquency and the options available to the borrower. In a fourth instance, Veterans Affairs reported to the VA that it sent a letter when it had not at that time. Veterans Affairs told us that it subsequently sent the letter but could not provide a copy.

- For three of the four loans in which Veterans Affairs made a foreclosure referral, Veterans Affairs reported the referrals from eight to 80 days late.
- For two of three loans that had a compromise sale, Veterans Affairs reported the sale one and 30 days late, respectively. A compromise sale is one in which the borrower's property is purchased by a third party for less than what is owed on the loan.
- For seven of the 25 loans we reviewed, Veterans Affairs reported loan defaults to the VA by submitting electronic default notifications (EDNs) from one to eight days late. EDNs alert the VA that a borrower is at least 61 days delinquent in their payments.
- For the one loan for which Veterans Affairs approved a repayment plan and for which reporting of the approval to the VA was required, Veterans Affairs did not report the approval.

At the time of our review, Veterans Affairs used a manual process to report most of the events for which we noted late reporting. A property agent in its collections unit stated that, to ensure timely reporting, Veterans Affairs was planning to include the reporting of these events in a single file submitted weekly to the VA— known as the bulk upload file. Additionally, although Veterans Affairs already uses the bulk upload process to report loan defaults on a monthly basis, the property agent noted that the file can be delayed by several days for a variety of reasons. The loan servicing operations manager indicated that holidays or mandatory furloughs caused one- or two-day delays in reporting certain loan defaults. Further, the manager explained that Veterans Affairs has experienced unprecedented levels of delinquencies since the electronic reporting requirements came into effect in late 2008. She also stated that Veterans Affairs focused on those events that could jeopardize claims against the VA-guaranty and that none of the concerns we have identified impacted Veterans Affairs' ability to collect on a claim. Further, she noted that the VA has not notified Veterans Affairs of any regulatory infractions, which are penalties the VA applies when a loan servicer fails to comply with VA regulatory requirements while servicing a loan. Nonetheless, Veterans Affairs' noncompliance with reporting requirements may hamper the VA's ability to conduct oversight on loans it has guaranteed.

Further, Veterans Affairs lacks a process to use the information in its system to determine which borrowers no longer have delinquent payments and therefore have cured their default. The property agent stated Veterans Affairs is working with its Information Services Division to develop a report that would provide such information. The agent stated that currently the event is reported only if a collections agent notices that a borrower has caught up with their payments. By not reporting defaulted loans that have been cured, Veterans Affairs limits the effectiveness of its default reporting. The VA requires servicers to report only one default notification when a borrower defaults on loan payments. The default cured event signals to the VA that a prior default is no longer in effect. If a borrower defaults again, Veterans Affairs should report a new default. However, when Veterans Affairs does not report when loan defaults are cured, the VA's reporting system automatically rejects subsequent default notifications submitted by Veterans Affairs that should be reported.

Finally, in our previous audit report for fiscal year 2008–09, we reported that Veterans Affairs was not reporting to the VA as required delinquent payments it reported to credit bureaus. In response, Veterans Affairs established a process and began reporting this information to the VA in March 2010. However, for the first eight months of fiscal year 2009–10, delinquent loans reported to the credit bureau were not reported to the VA. Of the 25 delinquent loans we reviewed, five became delinquent

in March 2010 or later and thus were subject to Veterans Affairs' new process. Veterans Affairs reported to the VA its reporting to the credit bureaus by the required date for four of the five loans. Veterans Affairs reported the fifth loan to the VA five days after the deadline.

We recommend that Veterans Affairs ensure that it establishes processes and procedures to report all required events to the VA within the applicable time frames. We further recommend that Veterans Affairs develop a process to identify those borrowers that have cured their defaults and report these events to the VA. In its corrective action plan, Veterans Affairs agrees that it did not report certain data according to the required time frames. However, it states that none of the reporting exceptions have had or will have any negative impact on its ability to file claims. Further, Veterans Affairs states that automation of the reporting requirement is a management priority and should resolve all noted issues. It has been working on this automation project and anticipates that the system will be in place by March 31, 2011.

### **Construction Contractors Working on Veterans Home Projects Did Not Always Appropriately Certify Their Payrolls**

Through the construction grant program, the VA provides financial assistance to states acquiring or constructing state veterans home facilities. The Davis-Bacon Act (Davis-Bacon) requires all contractors and subcontractors performing work on federally assisted contracts in excess of \$2,000 to pay their laborers and mechanics not less than the prevailing wage rate and fringe benefits for corresponding classes of laborers and mechanics employed on similar projects in the area. The prevailing wage rates and fringe benefits are determined by the U.S. Secretary of Labor. Federal regulations require specific clauses to be included in the construction contracts; the clauses include requirements that contractors submit copies of their payrolls on a weekly basis as well as a signed statement that certifies prevailing wages were paid.

The Department of General Services (General Services) acts as a project manager for the construction and renovation of veterans homes on behalf of Veterans Affairs and is also responsible for contracting for construction of the homes. In our prior-year audit report for fiscal year 2008–09, we reported that General Services did not include in its construction project contracts the clauses required by Davis-Bacon. General Services also did not collect the required weekly payrolls and certifications from the contractors. We reported that Veterans Affairs had not established written policies and procedures to communicate formally all Davis-Bacon requirements so that General Services could comply with federal requirements. Without ensuring that General Services includes all of the required contract language and collects weekly payrolls and certifications as required, Veterans Affairs does not have reasonable assurance that appropriate wages are being paid to construction laborers and, consequently, that it is complying with federal requirements.

During our follow-up procedures for fiscal year 2009–10, we found that the finding was partially corrected. Specifically, we found that General Services amended the construction contract for the federally funded veterans home that remained under construction in response to our finding for fiscal year 2008–09 to incorporate a reference to the Davis-Bacon regulation that contains the required contract language. However, we also found that General Services did not always obtain an appropriate payroll certification, known as a statement of compliance, from all of its contractors. A project director at General Services stated that it began receiving weekly certified payrolls in December 2009. We therefore reviewed three of the 26 weekly payrolls that were submitted from January 2010 through June 2010. For all three weeks, at least one contractor submitted a certification with its payrolls

that did not meet the federal requirement. The project director indicated that in the future General Services would require contractors to submit the statement of compliance form published by the U.S. Department of Labor that specifically meets the certification requirement.

Finally, we found that throughout fiscal year 2009–10 Veterans Affairs continued to lack written policies and procedures to communicate formally to General Services all applicable Davis-Bacon requirements. Veterans Affairs completed the policies and procedures in late October 2010. We reviewed the policies and procedures and found that, if followed, they were adequate to address our concern regarding Veterans Affairs' oversight of General Services' compliance with Davis-Bacon requirements. Specifically, the procedures include provisions for Veterans Affairs to ensure Davis-Bacon requirements are communicated to General Services and for Veterans Affairs to periodically verify that certified payrolls are submitted for a sample of contractors and work weeks. We recommend Veterans Affairs follow its newly established written policies and procedures. In its corrective action plan, Veterans Affairs indicates that is its intention.

### **Veterans Affairs Has Made Progress to Address Certain Concerns Involving Contractor Payments Under the Construction Grant Program**

Federal regulations require costs paid with federal funds meet certain criteria, including adequate documentation of the cost. Its grant agreement with the VA also requires Veterans Affairs to periodically inspect a veterans home project and certify the total costs payable by the VA. In addition, federal regulations require states to contribute at least 35 percent of project costs and that the nonfederal share of the costs contributed towards this requirement must be allowable. Finally, federal regulations require entities entering into contracts as part of a federal grant program to obtain assurance that the contractor is not suspended or debarred from participation in federally funded programs. Entities can do this by checking the federal Web site that lists parties that are excluded, collecting a certification from the contractor, or adding a clause or condition to the contract that certifies the contractor is not suspended or debarred.

In our prior-year audit report for fiscal year 2008–09, we reported that General Services could not always demonstrate that its inspectors reviewed pay requests from construction contractors. Additionally, we reported that for one of six pay requests we reviewed, General Services was unable to provide documentation that detailed the completed tasks for which a contractor was paid. Without this documentation, we were unable to determine whether the payment, which totaled \$1.4 million, was for allowable costs. Further, because the State uses its funds to pay a portion of the expenditures, the lack of documentation also prevents the State from demonstrating compliance that its matching funds were used for allowable costs. We also reported that General Services did not initially ensure that one of its construction contractors was not suspended or debarred, though it did obtain the appropriate certification from the contractor during our audit. We reported that Veterans Affairs had not established written policies and procedures to ensure that General Services complies with applicable federal requirements, increasing the risk that federal funds could be spent on unallowable costs or paid to contractors who are ineligible to work on federally funded projects.

During our follow-up procedures for fiscal year 2009–10, we found that Veterans Affairs had partially corrected this finding. Our fiscal year 2008–09 finding regarding the lack of documentation of an inspector's review of pay requests and that all tasks were completed for one pay request related to a single veterans home project. That project was completed in December 2009, and we formally informed Veterans Affairs of these issues in January 2010. Therefore, we did not review any payments

for this project for fiscal year 2009–10. However, to evaluate whether Veterans Affairs took corrective action since we informed them of the deficiencies, we reviewed payments to construction contractors for two new veterans home projects for which Veterans Affairs anticipates federal funding in March 2011 and found that the payments included adequate supporting documentation and General Services' inspectors had signed the payment requests. Additionally, General Services obtained suspension and debarment certifications from the construction contractors for the two new homes. Veterans Affairs anticipates the certifications from the contract consultants for the projects will be submitted by the time federal funds are received.

We also found that, as with the Davis-Bacon requirements, Veterans Affairs continued to lack written policies and procedures related to these requirements throughout fiscal year 2009–10. Veterans Affairs completed its policies and procedures in late October 2010. We initially found that the procedures did not include a process for Veterans Affairs to periodically verify General Services' processing of contractor pay requests. After we brought this to Veterans Affairs' attention, it promptly revised its procedures to include such a provision. We reviewed Veterans Affairs' revised policies and procedures and found that, if followed, they were adequate to address our concerns regarding Veterans Affairs' oversight of General Services' review of contractor payment requests and process for ensuring contractors are not suspended or debarred.

We recommend Veterans Affairs follow its newly established written policies and procedures regarding General Services' payments to contractors and verification that contractors are not suspended or debarred. In its corrective action plan, Veterans Affairs indicates that it plans to follow the new policies and procedures.

### **We Could Not Verify Certain of Veterans Affairs' Corrective Actions Related to Its Reporting of Construction Grant Program Costs**

Federal regulations require that states' financial management systems be able to permit the preparation of federally required reports and allow funds to be traced to a level of expenditures necessary to establish that such funds have been used appropriately. For grants for construction activities that are paid by reimbursement, federal regulations further require that grant recipients request federal funds on a standard request for reimbursement form.

As part of its project management, General Services pays construction costs and then prepares the request for reimbursement that it submits to Veterans Affairs. Veterans Affairs then authorizes the request for reimbursement and submits it to the federal government. In our prior audit report for fiscal year 2008–09, we reported that General Services did not have a sufficient process to ensure the costs it reported in the requests for reimbursement were supported by documentation. We reported that for five of the 18 requests for reimbursements we reviewed in fiscal year 2008–09, General Services shifted a portion of the costs from the *construction and project improvement* category to the *land development* and *demolition and removal* categories, indicating that it spent funds in those categories. However, General Services did not have documentation that it had verified that these costs were appropriately shifted to those cost categories. Although General Services was subsequently able to gather and provide documentation to us that identified the costs it included in the land development category for fiscal year 2008–09, its process did not include a step to perform this verification routinely before it shifted costs among categories on its requests for reimbursement. Without such verifications, the State could inadvertently request and receive federal funds for a

particular cost category that exceeds the amounts actually spent in the category. We also reported that Veterans Affairs was unaware of this situation even though it approves the requests for reimbursement and that there was a need for increased oversight.

We reviewed the requests for reimbursement for the project receiving most of the federal funding in fiscal year 2009–10. Since informing Veterans Affairs of our concern in late January 2010, its requests for reimbursement for the project have been limited to the *equipment* and *construction and project improvement* categories, with equipment accounting for the majority of funds requested. The expenditures in the equipment category are made by Veterans Affairs and follow a different process than the construction-related expenditures. Although we did not find any problems with the reporting of equipment expenditures, our finding for fiscal year 2008–09 was specific to General Services' process for reporting expenditures related to construction-related activities in the *land development* and *demolition and removal* categories. Veterans Affairs exhausted the federal funds available for these categories for its veteran home projects prior to the beginning of fiscal year 2009–10. As a result, we were unable to verify whether General Services corrected its process.

We also found that Veterans Affairs continued to lack policies and procedures designed to improve General Services' reporting of expenditures and Veterans Affairs' oversight of the reporting process throughout fiscal year 2009–10. We reviewed Veterans Affairs' policies and procedures that were subsequently completed in late October 2010 and found that, if followed, they were adequate to address our concerns regarding Veterans Affairs' oversight of General Services' reporting process. We recommend Veterans Affairs follow its new policies and procedures to ensure that the State is accurately reporting costs by category on the requests for reimbursement. In its corrective action plan, Veterans Affairs indicates that is its intention.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
State Auditor

Date: January 27, 2011

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

cc: Members of the Legislature  
Office of the Lieutenant Governor  
Milton Marks Commission on California State  
Government Organization and Economy  
Department of Finance  
Attorney General  
State Controller  
State Treasurer  
Legislative Analyst  
Senate Office of Research  
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