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Information Item

Audit Committee

Department of Finance "Assessment" Status Update

An oral update will be provided.

Responsible Staff: Keri Tippins,
General Counsel

CALIFORNIA STUDENT AID COMMISSION

EXECUTIVE OFFICE

CALIFORNIA STUDENT AID COMMISSION 1955—2005 50 YEARS SERVING STUDENTS

September 22, 2008

Kim A. Tarvin, CPA
Audit/Evaluation Manager
Department of Finance
Office of State Audits and Evaluation
915 L Street
Sacramento, CA 95814

Re: Concern that the Department of Finance is not Conducting an Independent Audit of the Issues Addressed by the California Student Aid Commission, but Rather, an "Assessment."

Dear Ms. Tarvin:

On September 17, 2008, the executive staff of the California Student Aid Commission (Commission) met with you and Arloa Singhsneh to provide information for the "independent review" being undertaken by the Director of Finance in response to the compensation and governance issues considered by the Commission at its September 4, 2008 meeting. The Commission and its staff welcome a comprehensive review of the issues raised by the Commission because they impact the Commission's statutory obligation to set policy for, and provide oversight of, its auxiliary organization. The Commission is equally interested in any findings that would improve the efforts of the Commission to administer the Federal Family Education Loan Program (FFEL Program) for California. As such, the Commission will cooperate fully with any comprehensive audit, whether conducted by the Department of Finance Office of State Audits and Evaluation, the Bureau of State Audits (BSA) or any other federal or state entity interested in the Commission's administration of the Federal Family Education Loan Program (FFEL Program) and its oversight of its auxiliary, EDFUND.

Commission staff does, however, have concerns with the "independent review" that the Director of the Department of Finance committed to and the manner in which that commitment is being fulfilled. While the Commission understood that the Director's reference to "independent review" meant an audit, you have informed us that the Department of Finance is not performing an audit. Instead, the Office of State Audits and Evaluation is undertaking an "assessment" of some of the matters raised during the September Commission meeting and reporting that information to the Director. " Considering the extensive role that individuals at the Department of Finance, including the Director, have had on the very issues being evaluated, the efficacy of such an "assessment" is questionable. The Director of Finance's actions after the September 4, 2008 Commission meeting provide the context of our concerns.

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During the September 4, 2008 meeting, the Commission sought to fulfill its legal responsibilities under federal law to administer the FFEL Program by taking action on several policy and governance matters related to the Commission's nonprofit auxiliary organization, EDFUND. The Commission adopted an amendment to its "California Student Aid Commission Policy on EDFUND Executive Compensation" (Tab Item 8) to prohibit severance agreements and retention bonuses for EDFUND executives and require Commission approval of EDFUND executive compensation. The Commission also streamlined and strengthened the EDFUND governance structure through the removal of the Board of Directors and the replacement of those individuals with the members of the Commission (Tab Items 9 and 10). The Commission also adopted a policy governing EDFUND contracts (Tab Item 5) as a result of a number of questionable contracts EDFUND had signed without the approval of the EDFUND Board and the Commission. The Commission also directed the rescission of any contract relating to a request for proposal for services for a media campaign that, contrary to Commission policies, was to advocate to members of Congress a policy position that had not been considered or approved by the Commission (Tab Item 4).

On September 5, 2008, the Director of the Department of Finance, Michael Genest, issued a letter disapproving the actions taken by the Commission on Tab Items 8, 9 and 10 pursuant to his understanding of his authority under Senate Bill 89. Mr. Genest further indicated that he would undertake an "independent review" of the issues raised by the Commission and that he would have the Office of State Audits and Evaluations in the Department of Finance complete that independent review.

The "assessment" process you described raises several areas of concern for Commission staff. In particular, the process cannot be independent because Mr. Genest, as well as Fred Klass, Chief Operating Officer of the Department of Finance, played an active role in some of these issues before the Commission's September 4 meeting. Informing them of their own actions so that they can approve or disapprove a Commission action that may be inconsistent with the way they have already acted appears futile. In addition to the lack of independence, it is unclear what standards will be followed in completing this "assessment". An audit would require that specific standards be followed to ensure credibility and independence.

Illustrative of these concerns is the first issue raised during your meeting with Commission staff. You inquired whether the Commission had knowledge of any continuing attempts by EDFUND to increase the compensation of its Executive Management Team, or individual members thereof. As was fully documented in the materials provided for Tab Item 8, EDFUND has used State funds to hire two law firms, one of which is also a lobbying firm, in an attempt to keep its severance discussion from being subject to public review as required by the Bagley-Keene Open Meeting Act. EDFUND has enlisted the assistance of Mr. Klass, and Mr. Genest in getting approval of a severance or retention bonus contrary to the Commission's direction on the issue, and persisted, as recently as its August 2008 meeting, in considering a compensation adjustment for EDFUND executives through base salary increases that may not be warranted in current circumstances, especially considering the present financial climate.

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The Commission has repeatedly indicated to the Chair of the EDFUND Board, and in public statements made during Commission meetings, that it opposes severance agreements for EDFUND executives. In an attempt to ensure that EDFUND did not act to increase the compensation of EDFUND executives, the Commission amended its own policy to require that all changes to executive compensation had to be approved by the Commission and to prohibit severance agreements and retention bonuses for EDFUND executives. This was the particular policy change that was overruled by Mr. Genest on September 5, 2008 without any analysis or explanation.

Commission staff is aware that in June 2008, Mr. Genest, Mr. Klass, and the Department of Finance Chief Counsel, met with representatives of EDFUND, including the Chair of the EDFUND Board of Directors, Chair of the EDFUND Finance Committee, and EDFUND-hired lawfirm/lobbyist, as well as the then-Commission Chair and Vice Chair, and the Commission's General Counsel. This meeting occurred after the EDFUND Board's attempt to award $4 million in severance agreements for EDFUND executives had come to light. During the June 2008 meeting, Mr. Genest stated that the $4-million severance bonuses were not acceptable but that he could accept a retention bonus for a more limited number of EdFund executives.

By letter dated August 29, 2008, the former Chair of the Commission provided Mr. Genest with documentation of this meeting, as well as other facts relating to the issues the Commission would be discussing at the Commission's September 4 meeting. During our meeting with you on September 17th, you referred to that letter. It is our understanding that the former Chair, an appointee of the Governor, was trying to alert the Governor's Office about the Commission's concerns in order to avoid an adverse effect on the Administration.

The information provided in the August 29, 2008 letter included a recounting of the June 2008 meeting. Upon seeing the description of his statement that the $4-million severance bonuses were not acceptable but that he could accept a retention bonus for a more limited number of EdFund executives, Mr. Genest asserted that it was a completely false statement. However, when confronted by a confirmation of that statement by a person who had participated in the meeting, Mr. Genest retreated from his absolute assertion of falsity to explaining in detail how "tone is everything." You may want to ask Mr. Genest for the e-mail messages, which occurred around September 3, 2008. Commission staff will be able to get these for you if Mr. Genest does not make them available to you.

As a result, a reasonable inference drawn from the EDFUND Board's actions in continuing to seek a salary adjustment for EDFUND executives, and the Director of Finance's overruling of the Commission's policy which prohibited severance and retention bonuses and gave the Commission the authority to review any compensation changes for EDFUND executives, is that both EDFUND and Finance are actively working to enhance the compensation of EDFUND executives. The active role played by both Mr. Klass and Mr. Genest in the compensation of EDFUND executives makes it likely that they are the two individuals with the most accurate information on whether EDFUND is continuing to seek increases in the compensation of EDFUND executives.

Thus, considering the involvement of Mr. Genest, the highest ranking official in the Department of Finance, and Mr. Klass, the Chief Operating Officer, an “assessment” performed by the Department of Finance’s own Office of State Audits and Evaluations to advise Mr. Genest cannot be perceived as independent.

This lack of “independence” by the entity performing this “assessment” is of significant concern to Commission staff. If this were an audit that adhered to standards it would be clear that it was not being conducted independently. Government Auditing Standards (“Yellow Book”) includes the professional standards and guidance commonly referred to as generally accepted government auditing standards (GAGAS) and provides a framework for conducting high quality government audits and attestation engagements with competence, integrity, objectivity, and independence (Section 1.03). As is noted in Introduction, Section 3.01, of the Yellow book:

> This chapter establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under generally accepted government auditing standards. … These general standards, along with the overarching ethical principles presented in chapter 2, establish a foundation for credibility of auditors' work. These general standards emphasize the independence of the audit organization and its individual auditors ...

Sections 3.02 and 3.03 expands on the “Independence” of the audit organization and states:

> In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence.
>
> Auditors and audit organizations must maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. Auditors should avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that the auditors are not able to maintain independence and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

While it has been made clear to Commission staff that the Office of State Audits and Evaluations is <u>not</u> performing an audit, the absence of any clear standard by which this “assessment” is being conducted adds to the problematic nature of the assessment being executed by an entity which lacks independence with the issues being assessed.

The fact that you indicated that your task is to do an assessment, not an audit, is also problematic. Commission staff is aware that when initially informed by Mr. Genest that Department of Finance auditors would be involved, the former Chair of the Commission questioned the perception of lack of independence and suggested to Mr. Genest that the

BSA would be more appropriate. Mr. Genest reportedly asserted that BSA could not perform the audit in a timely manner, that its yearly audit schedule had already been set, and that it would require a request from the Legislature.

Commission staff believes that BSA would be an appropriate party to conduct the audit because BSA has audited CSAC and EDFUND, most recently in April 2006, and the issues are of such significance that, at a minimum, an inquiry should be made of BSA as to whether it could amend its audit schedule and complete an audit in a timeframe that would be acceptable to all parties.

Another item which raises questions about the Commission's being presented the opportunity to have an independent entity review is the unwillingness of the Department of Finance to share with the Commission the allegations made by EDFUND against the Commission. The Commission has clearly and publicly documented its basis for making the policy and governance changes that it took at its September 2008 meeting. The organization that was the subject of these changes, EDFUND, has made allegations against the Commission which have never been shared with Commission staff.

As a result of the issues set forth above, the Commission staff is very concerned about the credibility of any decision by the Director of the Department of Finance based on this assessment of the issues considered by the Commission. Under federal law, and from the perspective of the United States Department of Education (USDE), the Commission is fully and solely responsible for the administration of the student loan guarantee program in California, not the Department of Finance. Thus, any decision by the Department of Finance that is contrary to Commission action places at risk the status of USDE's designation of the Commission as the designated student loan guarantee agency for California.

At our next meeting with you, Commission staff would appreciate the Department of Finance's clarification on the issues of independence, the standards by which the "assessment" will be conducted and the allegations by EDFUND against the Commission.

If you have any questions, or would like to discuss the concerns expressed above, please do not hesitate to contact me at (916) 464-8135.

Sincerely,

Keri Faseler Tippins
General Counsel

DEPARTMENT OF FINANCE

ARNOLD SCHWARZENEGGER, GOVERNOR

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Transmitted via e-mail

September 25, 2008

Ms. Diana Fuentes-Michel, Executive Director
California Student Aid Commission
P.O. Box 419026
10834 International Drive
Rancho Cordova, CA 95741-9026

Dear Ms. Fuentes-Michel:

This is in response to the September 22, 2008 letter from the California Student Aid Commission (Commission) regarding the Office of State Audits and Evaluations' review of both Commission and EdFund concerns that were reported to the Department of Finance (Finance).

The review was requested by Finance's Director in response to the Commission's August 29, 2008 letter expressing concerns related to EdFund. Subsequently, EdFund expressed concerns related to the Commission. As discussed with you and your staff on September 17, 2008, this review is intended to evaluate the Commission and EdFund's concerns, determine whether these concerns are substantiated, and provide information to the Finance Director.

On September 17, 2008, we indicated that we were not releasing the Commission or EdFund letters to either party. However, we stated that we would discuss each of the concerns with you and your staff to obtain any additional information or documentation related to each concern. The specific EdFund concerns were not discussed at the September 17, 2008 meeting due to time limitations. As a result, we requested to meet again on September 23, 2008, to continue discussing the Commission's and EdFund's concerns. However, at the conclusion of the September 17, 2008 meeting, the Commission's General Council recommended that the Commission staff not continue discussions regarding the issues unless the EdFund letters were released to the Commission.

On September 22, 2008, I sent an e-mail notifying you that while we were not releasing the EdFund letters to the Commission, we would like to continue with the meeting on September 23, 2008 to discuss both the Commission's and EdFunds concerns. Further, I indicated that a meeting to discuss the issues would be beneficial for us to gain a full understanding of all the issues and any additional documentation that would support the Commission's point of view regarding both the Commission's concerns and the additional concerns brought forward by EdFund. Furthermore, I notified you that if the Commission staff chose not to meet with us, we would be required to report that the Commission was unwilling to meet with us and indicate that this lack of information would impact our ability to review the concerns not yet discussed. You replied that the Commission would be available to continue discussions. Due to availability, the September 23, 2008 meeting was rescheduled for September 29, 2008.

We believe that a review of the concerns is both appropriate and more cost effective for providing timely information to the Finance Director. After the results of the review are known, some of the concerns may be recommended for an audit type of engagement. If the Commission wishes, it could contract with another audit entity to conduct an audit of any areas that it feels would be appropriate.

If you have any further questions, please contact Kimberly A. Tarvin at (916)322-2985, Ext. 3152.

Sincerely,

David Botelho
Office of State Audits and Evaluations
(916) 322-2985