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Information/Action Item

California Student Aid Commission

Consideration of the State of California Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009, issued by the Bureau of State Audits on March 30, 2010

The Bureau of State Audits (BSA) has issued its annual federal compliance audit of the State of California. This report entitled the "Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009" includes a review of the California Student Aid Commission's administration of the Federal Family Education Loan (FFEL) Program for fiscal year 2008-09. The excerpted audit report, containing the findings applicable to the Commission, may be found at Tab 5.a.

The audit report contains two findings relating to the Commission and its participation in the FFEL program through its auxiliary, EdFund.

Finding 1

BSA's first finding relates to information security concerns. BSA found that EdFund had failed to fully address 27 of 50 high-risk findings identified by an EdFund contractor who conducted a security risk analysis in January 2009. BSA expressed concern that "weaknesses identified in EdFund's information security have the potential to result in insufficient protection of sensitive or critical computer records." In addition, in a previous report BSA had found that certain types of data transactions were not logged on its system and there was therefore a risk as to whether EdFund was maintaining current, complete, and accurate records for each loan. EdFund claims that it resolved this weakness in its system on May 27, 2009. However, because this issue was fixed late in the 2008-09 year, BSA is unable to determine whether EdFund "maintained current, complete, and accurate records for each loan it held during fiscal year 2008-09."

For Finding 1, BSA has recommended the following:

Student Aid should ensure that EdFund takes the following steps to maintain current, complete and accurate records for each loan it holds:

- Continue to address all of the high-risk findings in its 2009 security risk assessment.
- Ensure that it maintains a complete history or audit trail of all changes made to its data.

Commission staff provided a response to BSA which may be found under the heading "Department's View and Corrective Action Plan" on page 74 of the audit report. Commission staff concurred with BSA's finding and recommendations.

Corrective Action for Finding 1

Commission staff will be drafting a corrective action plan for the Commission's consideration at a future Commission meeting.

Finding 2

BSA's second audit finding relates to inappropriate expenditures made by EdFund for unallowable or unreasonable EdFund expenditures, employee meals while travelling, employee meals with industry contacts, catering costs associated with training events for schools, catering for EdFund employee trainings, staff recognition and miscellaneous expenditures. There was also an issue with EdFund's internal controls over accounts payable. BSA has recommended the following for Finding 2:

To stengthen its reimbursement process Student Aid should:

- Ensure that EdFund's proposed and existing policies and procedures are adequate to reasonably ensure compliance with federal and state laws and regulations relevant to the FFELP.
- Student Aid should also enforce the provision of the operating agreement requiring EdFund to provide it with the appropriate supporting documentation.
- Finally, if Student Aid believes it needs additional authority to compel EdFund to allow it to review proprietary and confidential information related to EdFund's expenditures, it should seek clarifying legislation.

To ensure that future Operating Fund expenditures are for only allowable activities and costs, Student Aid should:

- Ensure that EdFund modifies its business expense reimbursement policy to incorporate the changes made by its vice president of Client Solutions and Services' January 13, 2010 email.
- Ensure that EdFund specifically defines the permissible exceptional circumstances that would fall outside of its travel policy and require the chief financial officer to exercise his authority.
- Ensure that EdFund modifies its FFELP program code of conduct policy to include a dollar threshhold that defines nominal value for refreshments provided at school-related training events.
- Ensure that EdFund modify its training policy to limit the meal-related costs of internal-training functions to some reasonable standard, such as the IRS per diem rates.
- Ensure that EdFund modifies its procurement/contracts policy to specifically prohibit individuals from being able to approve their own payments.
- Ensure that EdFund requires its employees to submit receipts with their travel expense claims that itemize their purchases.

Commission staff concurred with BSA's finding and recommendations and provided a detailed response to BSA for this Finding. BSA found the response to lengthy to be incorporated in its report and only included a summary of the staff response within its report. That summary may be found under the heading "Department's View and Corrective Action Plan" on page 82 of the audit report. The original response made by Commission staff is provided for your information at Tab 5.b.

Corrective Action for Finding 2

As noted in BSA's report, the Commission has had significant concerns with EdFund expenditures since September 2008. Numerous other inappropriate expenditures made by EdFund were not reviewed by BSA because they were not within the scope of this particular BSA Audit. As a result of these ongoing, significant concerns, staff is making additional recommendations beyond those indicated by BSA in its report.

<u>Commission Staff Recommendation 1</u>:

Implement all BSA recommendations. Staff recommends, however, that each of the policies mentioned by BSA be evaluated to ascertain where rules on expenditures should more closely align with State of California practices instead of, for example, the IRS per diem rates because the funds being expended are state funds.

<u>Commission Staff Recommendation 2:</u>

Amend certain provisions of the Operating Agreement (OA) to improve administration of the program and tighten fiscal controls. The OA paragraphs to be amended, include, but are not limited to:

- Paragraph 4.4 "Compliance"
- Paragraph 4.5 "EdFund Policies"
- Paragraph 6.2 "Reimbursement of EdFund Expenses"
- Paragraph 6.5 "Travel Expenses"
- Paragraph 9.15 "Dispute Resolution"

<u>Commission Staff Recommendation 3:</u>

Require EdFund to submit two the reports specified in the Commission's Governance Policy. The first report is the "Monitoring Policy 1: Overall Compliance with Commission Policies" found in the Governance Policies most recently amended on June 26, 2008. This report is to be submitted by the EdFund President at the June 2010 meeting. This report is a certification on EdFund's compliance with Commission policies. This certification should cover the July 1, 2009 through June 15, 2010 time frame.

The second report is the "Monitoring Policy 6: Fiscal Operations" which would relate to EdFund's compliance with the Commission's Fiscal Operations Policies and the Loan Program report component.

Commission Staff Recommendation 4:

Modify the procurement/contracts policy to specifically prohibit certain lobbying, consultant and legal contracts from being entered into by EdFund without prior Commission approval.

Responsible Person(s): Keri Tippins
General Counsel

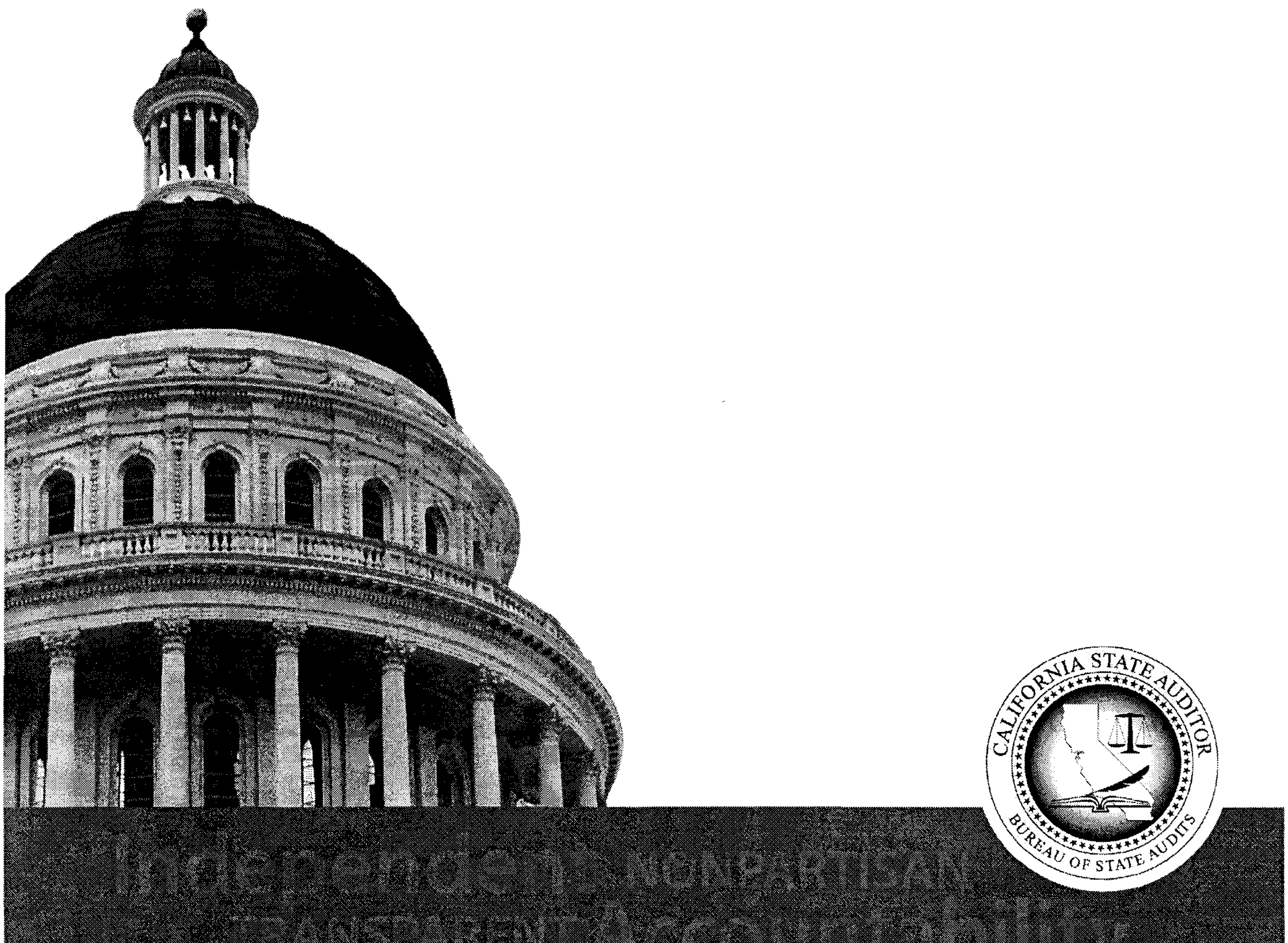
Tab 5.a

CALIFORNIA STATE AUDITOR

State of California:

Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009

March 2010 Report 2009-002



Category of Finding:	Special Tests and Provisions
State Administering Department:	California Student Aid Commission (Student Aid)

Criteria

TITLE 34—EDUCATION, PART 682—FEDERAL FAMILY EDUCATION LOAN (FFEL) PROGRAM, Subpart D—Administration of the Federal Family Education Loan Programs by a Guaranty Agency, Section 682.414—Records, Reports, and Inspection Requirements for Guaranty Agency Programs

(a) Records. (1)(i) The guaranty agency shall maintain current, complete, and accurate records of each loan that it holds, including, but not limited to, the records described in paragraph (a)(1)(ii) of this section. The records must be maintained in a system that allows ready identification of each loan's current status, updated at least once every 10 business days. Any reference to a guaranty agency under this section includes a third-party servicer that administers any aspect of the FFEL programs under a contract with the guaranty agency, if applicable.

CALIFORNIA CODES, EDUCATION CODE, Section 69522, (a)(1)

The commission may establish an auxiliary organization for the purpose of providing operational and administrative services for participation by the commission in the Federal Family Education Loan Program, or for other activities approved by the commission and determined by the commission to be all of the following:

(A) Related to student financial aid.

(B) Consistent with the general mission of the commission.

(C) Consistent with the purposes of the federal Higher Education Act of 1965 (Public Law 89-329) and amendments to that act.

Condition

EdFund, Student Aid's auxiliary organization, administers the FFEL Program and is required by its operating agreement with Student Aid to provide information security over Student Aid's and EdFund's confidential data. However, in past years we found that EdFund had not developed adequate internal controls over its information systems to provide reasonable assurance that it keeps current, complete, and accurate records of each loan.

In June 2005 EdFund hired a contractor that completed a security risk assessment. EdFund has made significant progress by fully addressing all the 2005 security risk assessment high-risk and moderately high-risk findings. However, weaknesses in EdFund's controls over information security still exist. Specifically, in January 2009, an EdFund contractor performed a new security risk assessment. The contractor identified 57 high-risk findings. Although, as of January 2010, EdFund was able to fully address 30 findings, it still has 27 findings to resolve and it had not begun to address four of them. Weaknesses identified in EdFund's information security have the potential to result in insufficient protection of sensitive or critical computer records.

We previously reported that EdFund did not maintain a complete history or audit trail of the changes made to the data. In October 2007, EdFund implemented a project designed to create an audit trail of such changes. However, the resulting audit trail did not track certain types of transactions related to collections and accounting. EdFund stated that on May 27, 2009, it fixed the system to enable logging of all transactions, including those related to collections and accounting. However, we were unable to determine whether EdFund is in fact logging all transactions because the changes to the data were made between May 27, 2009, and June 30, 2009. Thus, by not maintaining a complete history or audit trail of the changes made to the data prior to May 27, 2009, including changes made to transactions related to collections and accounting, EdFund cannot ensure that it maintained current, complete, and accurate records for each loan it held during fiscal year 2008–09.

Questioned Costs

Not applicable.

Recommendations

Student Aid should ensure that EdFund takes the following steps to maintain current, complete, and accurate records for each loan it holds:

- Continue to address all of the high-risk findings in its 2009 security risk assessment.
- Ensure that it maintains a complete history or audit trail of all changes made to its data.

Department's View and Corrective Action Plan

Student Aid stated that it concurs with our findings and recommendations. Student Aid also stated that the operating agreement between it and EdFund includes provisions to appropriately require EdFund to maintain strong control over its information systems including an audit of the information technology controls. The operating agreement, Article VIII Section 8.2.B, requires that "an independent certified public accountant shall provide Student Aid and the EdFund board an annual audit of key system and non-system internal controls affecting the initiation, authorization, recording, processing and/or reporting of transactions . . ." However, the Annual Audit of Internal Controls shall be performed only if the expenses associated therewith are approved by the California Department of Finance." Student Aid stated that the Department of Finance has not approved funding for this audit.

EdFund management informed Student Aid staff that EdFund will address all of the high-risk findings from the 2009 security risk assessment by June 30, 2011. EdFund management has also indicated that it has addressed the stated observation regarding EdFund's electronic detective controls over data maintenance through changes to the Financial Aid Processing System. The same systematic audit trail for the remaining files in which such transactions are conducted for data maintenance was completed in May 2009.

Student Aid staff will recommend to the commissioners for their consideration a corrective action plan to ensure EdFund takes steps to maintain current, complete and accurate records for each loan it holds.

Reference Number:	2009-14-9
Federal Catalog Number:	84.032
Federal Program Title:	Federal Family Education Loan Program
Federal Award Number and Year:	None; State Fiscal Year 2008–09
Category of Findings:	Activities Allowed or Unallowed; Special Tests and Provisions #9—Federal Fund and Agency Operating Fund
State Administering Department:	California Student Aid Commission (Student Aid)

Criteria

TITLE 34—EDUCATION, PART 682—FEDERAL FAMILY EDUCATION LOAN (FFEL) PROGRAM, Subpart D—Administration of the Federal Family Education Loan Programs by a Guaranty Agency, Section 682.423—Guaranty Agency Operating Fund

(C) Uses. A guaranty agency may use the Operating Fund for—

(1) Guaranty agency-related activities, including—

(i) Application processing;

(ii) Loan disbursement;

(iii) Enrollment and repayment status management;

(iv) Default aversion activities;

(v) Default collection activities;

(vi) School and lender training;

(vii) Financial aid awareness and related outreach activities; and

(viii) Compliance monitoring; and

(2) Other student financial aid-related activities for the benefit of students, as selected by the guaranty agency.

CALIFORNIA CODES, EDUCATION CODE, Section 69522, (a)(1)

The commission may establish an auxiliary organization for the purpose of providing operational and administrative services for the participation by the commission in the Federal Family Education Loan Program, or for other activities approved by the commission and determined by the commission to be all of the following:

(A) Related to student financial aid.

(B) Consistent with the general mission of the commission.

(C) Consistent with the purposes of the federal Higher Education Act of 1965 (Public Law 89-329) and amendments to that act.

CALIFORNIA CODES, EDUCATION CODE, Section 69522(d)(1)(A)

(d)(1)(A) The operations of the auxiliary organization shall be conducted in conformity with an operating agreement approved annually by the commission. On and after January 1, 2002, the commission may approve an operating agreement for a period not to exceed five years. Prior to approval, the commission shall provide a copy of the proposed operating agreement to the Department of Finance and the Joint Legislative Budget Committee for their review and comment. The operations of the auxiliary organization shall be limited to services prescribed in that agreement.

CALIFORNIA CODES, EDUCATION CODE, Section 69521.5

(a) The Director of Finance is authorized to take all actions that she or he deems to be necessary or convenient to accomplish any of the following:

(1) To preserve the state student loan guarantee program assets, pending consummation of their sale or the consummation of any other transaction, to maximize the value of the state student loan guarantee program to the state, including, without limitation, as authorized in sections 69522, 69526, and 69766.

CALIFORNIA CODES, EDUCATION CODE, Section 69526

(c) The commission, in consultation with the Department of Finance and the board of directors of the auxiliary organization, shall do all of the following:

(1) Institute a standard accounting and reporting system for the management and operations of the auxiliary organization.

(2) Implement financial standards that will ensure the fiscal viability of the auxiliary organization. The standards shall include proper provision for professional management, adequate working capital, adequate reserve funds for current operations and capital replacements, and adequate provisions for new business requirements.

(3) Institute procedures to ensure that transactions of the auxiliary organization are consistent with the mission of the commission.

(4) Develop policies for the expenditure of funds derived from indirect cost payments not required to implement paragraph (2). The use of those funds shall be regularly reported to the board of directors.

Condition

Background

The U.S. Office of Management and Budget's Circular A-133 Compliance Supplement (A-133 Compliance Supplement) issued in March 2009 suggests that auditors test expenditures of the Operating Fund to ascertain if they were made for allowable purposes. The A-133 Compliance Supplement also requires auditors to obtain an understanding of the entity's internal controls to assess if they are adequate to reasonably ensure compliance with federal laws and regulations relevant to the program. Our determination of whether or not Operating Fund expenditures were for allowable purposes is based primarily on federal regulations, state laws and regulations, the operating agreement between Student Aid and its auxiliary organization—EdFund, and a review conducted by the Department of Finance (Finance).

According to state law, the contents of the Operating Fund are state funds within the custody and control of Student Aid. Federal regulation states that allowable uses of the Operating Fund are limited to guaranty agency-related activities and other student financial aid-related activities for the benefit of students as selected by the guaranty agency, which is Student Aid. In January 1997 Student Aid advanced $20 million to EdFund for operating capital. EdFund uses this advance to pay its monthly operating expenses and it receives reimbursements from the Operating Fund. The operating agreement between Student Aid and EdFund establishes the reimbursement process. Specifically, the operating agreement requires EdFund to submit periodic invoices to Student Aid and to provide Student Aid with the appropriate supporting documentation and, if system security permits, read-only access to its accounting system. Student Aid is responsible for reviewing invoices and approving payments.

In September 2008 Student Aid publicly expressed concerns with, among other things, expenditures of public funds by EdFund that were inconsistent with the operational support it was to provide to Student Aid. In October 2008 Finance conducted a review of the concerns raised by Student Aid. Finance substantiated two of the four concerns regarding expenditures of public funds as well as Student Aid's concern with some items contained in EdFund's fiscal year 2008–09 proposed budget. In regards to the results of Finance's review, EdFund told us that it did not receive a written or verbal directive from Finance to change its spending practices and that Finance did not request it to report back on the resolution of any particular allegations that were substantiated.

Opportunities Exist to Strengthen the Reimbursement Process

During our review of the internal controls related to expenditures, we identified the reimbursement process as a key internal control over the use of the Operating Fund. We found that Student Aid's review of EdFund's invoices can sometimes result in the identification of potentially unallowable expenditures. Specifically, in a September 2009 letter to Finance, Student Aid stated that it had recently notified EdFund that it would not reimburse 171 expenditures, totaling roughly $189,000, made between May 2008 and June 2009.

The operating agreement allows Student Aid to withhold payment for any disputed expenditures and requires it to notify EdFund in writing, within 30 days, of the expenditure it is withholding and its reason. EdFund has the right to appeal Student Aid's decision in accordance with the dispute resolution process outlined in the operating agreement and shown in the textbox. However, in some instances it appears as though Student Aid's reasons for withholding payments could be resolved by more effective communication between it and EdFund. Specifically, in its September 2009 letter to Finance, Student Aid was concerned that EdFund continued to use state funds to make payments similar to those Finance substantiated as improper gifts of public funds. Although the payments may have been made by EdFund in accordance with its policies, Student Aid's review process does not require it to examine EdFund's policies or practices that may need to change as a result of issues Student Aid identifies during the reimbursement process.

Currently, the operating agreement requires EdFund to submit any proposed policies having a potential material effect on the Operating Fund to Student Aid and the EdFund board for review and approval. The operating agreement also requires EdFund to make its policies and procedures available to Student Aid for review and to submit any new or revised policy to Student Aid within 10 days of adopting the policy. Thus, it appears Student Aid has the authority to review EdFund's policies and request revisions to those that affect the Operating Fund so that it can prevent improper uses of state funds.

We also noted that in a few instances Student Aid withheld payment because EdFund did not provide it with supporting documentation related to the expenditures. Student Aid stated that, in cases when EdFund indicated why it would not provide the documentation, it often stated that the information was confidential or proprietary. However, as previously mentioned, the operating agreement requires EdFund to provide Student Aid with the appropriate supporting documentation and, if system security permits, read-only access to its accounting system. Until Student Aid strengthens its reimbursement process, it cannot ensure that Operating Fund expenditures are only for allowable purposes.

Unallowable or Unreasonable EdFund Expenditures

Based on our concerns with the reimbursement process and the concerns raised about EdFund's spending practices by Student Aid, we expanded our initial sample of 46 randomly selected expenditures by judgmentally selecting and reviewing an additional 45 expenditures. In summary, we found that of the 45 additional expenditures totaling $126,852 tested 16 expenditures totaling $29,233 (23 percent) were either partially or wholly unallowable because they did not benefit students or were unreasonable because the amounts spent did not appear to be prudent uses of state funds. We also noted that, for seven of the 45 expenditures, EdFund's internal controls need improvement because it reimbursed its employees for meals even though they did not provide receipts that itemize their meals.

Dispute Resolution Process

1. Parties shall attempt in good faith to resolve through informal negotiation any issue, dispute, claim, controversy and/or breach (breach) arising out of or relating to the operating agreement.
2. Any breach that cannot be so resolved shall first be presented to the respective contract managers for Student Aid and EdFund.
3. If the respective contract managers cannot resolve the issue within five business days, the issue shall be presented to the executive director of Student Aid or a designee of the governing body of Student Aid and the president of EdFund or designee of EdFund. The executive director or designee and the president or designee shall make every good faith effort to resolve the issue.
4. In the event the breach cannot be resolved by the executive director or designee and the president or designee within five business days of receipt, the chairs of Student Aid and the EdFund board shall be notified and a joint meeting of Student Aid and the EdFund board shall be noticed and shall take place within 20 business days of reporting the issue to the chairs to attempt to resolve the breach.
5. In the event the breach cannot be resolved by Student Aid and the EdFund board, Student Aid's decision shall be final.
6. In the event EdFund disagrees with Student Aid's final decision, EdFund may move forward with mediation.
7. In the event of a breach, nothing shall prevent Student Aid or EdFund from pursuing all other legal avenues available to the parties, including but not limited to legal action. However, both parties agree that prior to any legal action they will attempt to resolve their issues in an amicable manner through mediation.

Employee Meals While on Travel

EdFund employs a nationwide workforce of client services representatives and pays for their travel-related expenses, including meals. According to EdFund's travel policy and guidelines, travelers must claim reimbursement for meals based on city-specific per diem rates for meals and incidental expenses published by the U.S. Internal Revenue Service (IRS). These IRS rates are the maximum per diem rate an employer can use without treating the part of the per diem allowance exceeding the maximum rate as taxable wages. In addition to its travel policy and guidelines, EdFund's business expense reimbursement policy allows employees to receive reimbursement for meals if the meal relates to specific EdFund business goals. However, the business expense reimbursement policy does not dictate that employees stay within the IRS city-specific per diem rates.

We asked EdFund's vice president of Client Solutions and Services about the apparent absence of dollar limits in its business expense and reimbursement policy. The vice president stated that EdFund employees have always been expected to use good judgment and ensure, along with their managers, that the business expenses they submit for reimbursement are appropriate, reasonable, and justifiable. The vice president provided a June 2009 e-mail she sent to client services and client training staff stating that, as a rule of thumb and as a gauge for what is considered a reasonable for business expenses, a per-person meal charge that is similar to the per diem amount for the location is appropriate. However, because the business expense reimbursement policy does not specifically require the use of the IRS per diem rates and the vice president's e-mail was not sent until June 2009, this benchmark does not appear to have been used during most of fiscal year 2008–09—the time period of our review.

We selected 18 expenditures charged as EdFund business expenses primarily related to employee meals. We found that five of the 18 expenditures were instances where EdFund employees charged restaurant meals to the business expense—other account and stated they were discussing business to justify the expenditure. In one instance, a dinner for three employees cost $210, which exceeded the employees' combined IRS city-specific per diem rate of $192. Under EdFund's business expense reimbursement policy, this March 2009 expenditure would technically be allowable because, as described on the expense report, it was a "Dinner meeting & strategy recap" and therefore fell under a policy exception for meals that relate to specific EdFund business goals. Although technically allowable under EdFund's policy, we consider this cost an unreasonable use of state funds.

For three of the remaining four expenditures tested, the average cost of one breakfast for six EdFund employees was $31 per person, the average cost of a lunch for seven EdFund employees was $32 per person, and the average cost of a dinner for three EdFund employees was $46 per person. The apparent absence of dollar limits in its business expense reimbursement policy leaves room for the high cost of employee meals described above. On January 13, 2010, the vice president sent an e-mail to EdFund's client services staff to address EdFund's travel and business expense reimbursement policies. The vice president stated that EdFund would continue to follow the per diem rates published by the IRS for meal and incidental expenses under its travel policy. However, effective immediately, staff may not submit future business meal expenses for reimbursement under its business expense and reimbursement policy.

Employee Meals With Industry Contacts

We also found three expenditures charged as EdFund's business expenses related to the cost of EdFund employees' meals with industry contacts that we believe were unreasonable uses of state funds. Specifically, in July 2008, EdFund paid $1,040 for a business meal attended by three EdFund employees and four industry contacts, which is almost $150 per person. The receipt included an ambiguously labeled item that, upon further follow-up with the restaurant, we determined to be a call number for a bottle of wine. However, because this item was not detected or corrected during its review and approval process of the employee's travel expense claim, EdFund reimbursed the employee for the cost of this item. EdFund's business expense reimbursement policy specifically prohibits the reimbursement of alcoholic beverages. After we brought this issue to EdFund's attention, the employee immediately acknowledged the mistake and provided us evidence that he had subsequently reimbursed EdFund $114 for the cost of this item. Although not as expensive, we noted another business dinner attended by

EdFund employees and industry contacts that was reimbursed to the same employee in June 2009. The average cost of the dinner on this occasion was $79 per person, which we believe is still unreasonable when compared to the IRS' daily per diem rate for the area of $64.

EdFund's chief financial officer stated that the employee's business expense related to the July 2008 dinner was permissible under EdFund's travel and business expense reimbursement policies. In particular, the chief financial officer emphasized that he is authorized to permit reimbursements for documented exceptional circumstances that fall outside of EdFund's travel policy. Yet, the employee stated that the July 2008 dinner was held in conjunction with an industry group quarterly meeting and it was EdFund's turn to host the dinner. Consequently, this expense does not appear to be an exceptional circumstance.

Catering Costs Associated With Training Events for Schools

Although federal regulations prohibit a guaranty agency, or its agent or contractor, from making certain payments or providing benefits to any school or school-affiliated organization, they do allow a guaranty agency to provide meals and refreshments that are reasonable in cost and that are in connection with certain training programs, workshops, and forums customarily used by the agency to fulfill its responsibilities under the federal Higher Education Act. A November 2007 Federal Register states that, by reasonable cost, the Secretary of Education anticipates that guaranty agencies will adhere to the "prudent person test."

We reviewed seven expenditures charged as EdFund business expenses related to catering costs for financial-aid-training events sponsored by EdFund. We found that the average cost of a catered meal at the EdFund-sponsored training events in our sample ranged from $4 per person up to $61 per person (including taxes, tips, and service charges). The costs were highest at an event held at the Omni Chicago Hotel in November 2008. There were 31 attendees from various universities, colleges, and institutes and four EdFund employees present at this particular event. Breakfast for this event totaled $2,107, or $60 per person and lunch totaled $2,147, or roughly $61 per person. The cost for the lunch included a $42 per person buffet and the drinks, service charges, and taxes made up the difference of $677. Although the prudent person test is difficult to quantify, the requirement that the costs associated with school-related training-events be prudent, indicates that there is some limit on what can be spent. In our view, providing a $60 per person breakfast or lunch is imprudent, unreasonable, and therefore potentially unallowable.

Moreover, EdFund's FFEL program code of conduct policy states that EdFund may provide refreshments of a *nominal value* for trainings, meetings, workshops, forums, and conferences it conducts in fulfillment of its responsibilities under the federal Higher Education Act. However, EdFund's policy does not define *nominal value* and its vice president of Client Solutions and Services did not respond to our inquiry regarding EdFund's definition of this term.

Catering for EdFund Employee Trainings

We also reviewed two expenditures charged as EdFund business expenses related to catering costs for training events or meetings held for EdFund employees. The "prudent person test" applied to school-related trainings is not applicable for this type of business expense, but similar to the business expense meals discussed earlier, the per diem rate established by the IRS provides a benchmark for evaluating the reasonableness of these expenditures. For one of these expenditures, EdFund spent $900 for daily breakfast at a three-day training event that had 23 attendees. Thus, the breakfasts averaged $13 per person. Given that 16 of the attendees were already on travel status, and would have been reimbursed for their meals anyway, this per-person cost appears to be reasonable. In contrast, EdFund spent nearly $80 per person to provide breakfast and lunch to 87 attendees on the first day of its National Client Services Meeting in January 2009 at the Hilton Sacramento Arden West hotel. The second day cost almost $77 a person for these two meals. The IRS Sacramento-area daily per diem rate of $59 is significantly lower than the per person amounts paid by EdFund for only two meals. Thus, these amounts appear unreasonable. In total, the catering for breakfast and lunch for these two days was almost $12,750.

In response to our inquiry regarding these costs, its vice president of Client Solutions and Services indicated that EdFund does not have a conference room that would facilitate this type of meeting and as such it was required to look at other facilities to host the meeting. The Hilton was selected because it was less than other facilities EdFund reviewed and was available. Because the hotel required a minimum level of catering, EdFund had to purchase the hotel's catering services. The vice president indicated that the food charges were only $60 per person on the first day and $58 per person on the second day because catering service charges were not "food charges" and were required by the hotel. The vice president also stated that, although not reflected on the agenda, the lunch periods were actually working lunches in which the employees continued to discuss the topics on the agenda. Finally, the vice president stated that if EdFund had required its employees to leave the facility to eat, it would have substantially reduced the amount of meeting time each day, which would result in adding an additional day to the agenda and incurring additional hotel charges.

The vice president provided us with a bid sheet that showed that EdFund reviewed three hotels to host this conference, one of which did not bid because it had no openings. Consequently, the costs associated with two hotels were the options considered for this conference. Although the hotel selected had a minimum catering service requirement of $7,500 in food and beverages, EdFund exceeded this amount. Further, because EdFund's travel guidelines state "meal per diem amounts include taxes and tips" and we are using per diem allowances as a basis for comparison purposes, it is appropriate to include the catering service charges in the per person cost calculation. Consequently, we still believe that the catering costs associated with the conference were unreasonable.

Staff Recognition and Miscellaneous Expenditures

In addition to meal costs, we also selected 19 expenditures charged to EdFund's staff recognition and miscellaneous expense accounts. We concluded, similar to Finance in its October 2008 review, that eight of the expenditures in our sample related to staff recognition were not allowable because they do not benefit students. Specifically, EdFund paid $1,490 for gift cards to present to its employees and almost $500 for staff recognition lunches. In one instance, EdFund approved payment for a $205 lunch classified as staff recognition, despite the fact that the employee did identify the staff she took to lunch. We also found that EdFund purchased 648 16-ounce tumblers from Starbucks, at a cost of nearly $6,500, to provide to its employees so that they could stop using the disposable cups at its coffee stations. Finally, we found that in October 2008 EdFund purchased flowers, at a cost of $104, as a gesture of sympathy for a bank representative. EdFund's use of corporate travel cards and purchase cards policy listed sympathy and congratulation flowers as an approved use of the purchasing card at the time of the purchase. However, according to an e-mail dated December 4, 2008, as a result of Student Aid questioning flower expenditures as part of its reimbursement process, EdFund discontinued purchasing flowers after December 2008. Effective February 1, 2010, EdFund revised its purchasing cards policy and no longer includes sympathy and congratulation flowers as an approved use.

Many of the items we questioned as to allowability are the same as those Student Aid refused to reimburse and our concerns are similar to those expressed by Finance's review. In its October 2008 review, Finance analyzed a two-year contract, not to exceed $93,000, that provided coffee services at no charge to EdFund employees. Because providing free coffee could be construed or interpreted as a gift of state funds, and because the free coffee did not "benefit students," Finance concluded that Student Aid's concerns were substantiated. Our review found that EdFund's last payment for the coffee services was in November 2008. Finance also substantiated concerns related to EdFund's proposed fiscal year 2008–09 budget items, including an employee celebration event budgeted for $25,000 and roughly $2,000 in proposed costs related to a health fair, walking program, and giveaways. Finance concluded that these items may indicate the need for an audit to determine whether other costs incurred by EdFund are unallowable under state and federal guidelines.

EdFund's chief financial officer explained that, other than the brief statement that it refrain from expending funds for employee celebrations and coffee services, EdFund did not receive a written or verbal directive from Finance to change its practices as a result of Finance's review. The chief financial officer added that the review was brief and informal. The chief financial officer also stated that the review as described in the engagement letter was one-time in nature and Finance did not ask EdFund to report back on the resolution of any particular allegations deemed "substantiated" in the letter. The chief financial officer told us that, although there was no specific directive or follow-up process, EdFund has of its own volition made changes to its practices including the elimination of the coffee services, health fair costs and the annual employee event specifically documented in Finance's review.

EdFund Needs to Strengthen Its Accounts Payable Review

During our review of expenditures we noticed certain practices related to paying expenses and reimbursing its employees that EdFund can strengthen to protect the Operating Fund. EdFund's procurement and contracts policy states that approvers or "authorized signers" have the primary responsibility to ensure that expenditures comply with corporate policy. As the dollar amount of the purchase increases, EdFund's policy requires approval from increasingly higher levels of management. For instance, while a manager can approve a purchase up to $2,500, the chief financial officer or president must approve purchases above $50,000. In addition to these individuals, EdFund's accounts payable staff ensure, among other things, that the supporting documentation related to an expenditure is sufficient and that the appropriate approvals have been obtained.

As mentioned earlier, one employee did not identify who she took to a staff recognition luncheon. We also found that this same employee, who used a corporate purchasing card to pay for the lunch, also approved her own invoice. Although EdFund eventually discovered this error and obtained the appropriate approval, it took more than seven months to do so. Strong internal controls do not allow individuals to approve their own payments because, among other things, it increases the risk of fraud. In a May 2008 report, EdFund's internal audit division had a similar concern. Specifically, it noted that in a few instances the authorized signer both prepared and approved purchase requisitions. The internal audit division recommended that EdFund update its policy to include language prohibiting the approval of purchases by individuals initiating the requisition. EdFund's management responded that it would revise the policy by September 2009 but, as of December 2009, it had not done so.

Our review of EdFund's reimbursement of employee meals found that, in seven of 10 instances, at least one receipt in the reimbursement request did not itemize the purchase. Although accounts payable procedures require employees to submit the original receipts with their travel and expense claims, the procedure does not specify that the receipts should itemize the purchases. As previously mentioned, EdFund's business expense reimbursement policy specifically prohibits the reimbursement of alcoholic beverages. If EdFund does not require its employees to submit itemized receipts it can unknowingly reimburse them for alcoholic beverages.

Questioned Costs

Any questioned costs identified are reimbursable to the Operating Fund.

Recommendations

To stengthen its reimbursement process, Student Aid should:

- Ensure that EdFund's proposed and existing policies and procedures are adequate to reasonably ensure compliance with federal and state laws and regulations relevant to the FFEL program.

- Enforce the provision of the operating agreement requiring EdFund to provide it with the appropriate supporting documentation.

- Seek clarifying legislation if it believes it needs additional authority to compel EdFund to allow it to review proprietary and confidential information related to EdFund's expenditures.

To ensure that future Operating Fund expenditures are for allowable activities and costs, Student Aid should:

- Ensure that EdFund modifies its business expense reimbursement policy to incorporate the changes made by its vice president of Client Solutions and Services' January 13, 2010 e-mail.
- Ensure that EdFund specifically defines the permissible exceptional circumstances that would fall outside of its travel policy and require the chief financial officer to exercise his authority.
- Ensure that EdFund modifies its FFEL program code of conduct policy to include a dollar threshhold that defines nominal value for refreshments provided at school-related training events.
- Ensure that EdFund modifies its training policy to limit the meal-related costs of internal training functions to some reasonable standard such as the IRS per diem rate.
- Ensure that EdFund modifies its procurement/contracts policy to specifically prohibit individuals from being able to approve their own payments.
- Ensure that EdFund requires its employees to submit receipts with their travel expense claims that itemize purchases.

Department's View and Corrective Action Plan

Student Aid stated that it concurs with the Bureau of State Audits' (bureau) findings and recommendations. Student Aid staff will recommend to its commissioners that they direct EdFund to modify its policies and procedures to comply with the bureau's recommendations. Student Aid staff will also recommend a corrective action plan to strengthen its reimbursement process and ensure that future Operating Fund expenditures are for only allowable activities and costs.

Additionally, Student Aid stated it believes it has both the authority and the statutory responsibility to review proprietary and confidential information related to EdFund's expenditures. However, EdFund does not agree. Student Aid staff will recommend to the commissioners that they explore all avenues to ensure Student Aid has access to all supporting documentation and the means to recover funds spent inappropriately.

Finally, Student Aid staff expressed concerns that Senate Bill 89 (Chapter 182, Statutes of 2007) complicates Student Aid's ability to fully implement the bureau's recommendations and actually facilitates EdFund's inappropriate expenditures. According to Student Aid, SB 89 authorizes Finance to sell the state's FFEL program assets, including EdFund, and to displace Student Aid's authority over the state's administration of the FFEL program. Student Aid further contends that SB 89 contradicts federal law. Student Aid also stated that under California law it must abide by SB 89 and accept Finance's assumption of responsibility for the FFEL program, absent a court ruling that SB 89 is unconstitutional because it conflicts with federal law.

The above text represents the bureau's summarization of Student Aid's response. The full text is available upon request at the bureau.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Since February 2008, when the majority of the current Commissioners of the California Student Aid Commission (Commission) assumed office, the Commission has acted diligently to exercise its statutorily-mandated oversight responsibilities for EdFund. Over the last two years, the Commission has questioned significant expenditures by EdFund and, has refused to reimburse EdFund with state funds for its inappropriate expenditures. Furthermore, in light of the current economic challenges facing the state which have resulted in layoffs, furloughs, increased student fees in higher education, threats of cuts in health care for low-income people and in K-12 funding, and a $20-billion state budget deficit, EdFund's blatant disregard for the state monies funding its operations is particularly egregious. For example the Commission has not reimbursed the following expenditures:

- a payment of almost $8 million to lenders under an illegal federal default fee strategy;
- a two-year contract for up to $93,000 to provide free coffee services to EdFund employees;
- The EdFund Board of Director's use of state funds to hire the law firm of Nielsen, Merksamer, Parrinello, Mueller & Naylor to meet with Finance to facilitate an EdFund Board closed session to potentially award almost $4 million in severance agreements for EdFund executive management if EdFund were sold, despite the Commission's objection to the closed session and to the severance agreements in general.

Despite the direction and actions of the Commission, EdFund's misuse of state funds continues unabated. As noted in this BSA report, many of the inappropriate uses of state funds by EdFund were previously identified, and in some cases disallowed, by the Commission. Accordingly, Commission staff concurs with the findings and recommendations of the BSA involving EdFund's inappropriate spending of state funds in the operation of the state's Federal Family Education Loan Program (FFEL Program) and staff will recommend to the Commission a corrective action plan to implement the BSA recommendations.

However, Senate Bill 89 (Chapter 182, Statutes of 2007) complicates the Commission's ability to fully implement BSA's recommendations and actually facilitates EdFund's inappropriate expenditures. SB 89 authorizes the Department of Finance (Finance) to sell the state's FFEL Program assets, including EdFund, and to displace the Commission's authority over the state's administration of the FFEL Program.

Federal law requires the single state agency designated by United States Department of Education (USDE) as the state guarantee agency to have sole responsibility for policy and operations of the loan guarantee program, including control of any auxiliary organization (20 USC § 1078(b)(K); 34 CFR 682.401 (b)(16)). USDE designated the Commission as California's guarantee agency. However, Finance's assumption of authority over and full responsibility for the FFEL Program in California through its exercise of authority of SB 89 prevents the Commission from compliance with its federal responsibilities.

The Commission contends SB 89 contradicts federal law. Under California law, however, the Commission must abide by SB 89 and accept Finance's assumption of responsibility for the FFEL Program, absent a court ruling that SB 89 is unconstitutional because it conflicts with federal law.

The Commission and USDE entered into a continuing agreement in 1978 authorizing the Commission to operate under the FFEL Program, making the Commission the designated state student loan guarantee agency for California. The Commission originally pursued the creation of an auxiliary as a result of competitive pressures that threatened to force the Commission out of the FFEL Program. In 1996, the Legislature enacted legislation authorizing the Commission to create a nonprofit auxiliary organization whose sole purpose is to provide operational and administrative services to the Commission for the Commission's participation in the FFEL Program. On January 2, 1997, the Commission created EdFund.

The oversight of EdFund has been problematic since its inception. As the 1998 BSA investigative report #I960207 concluded, the Commission's system for administering the FFEL Program created both legal and ethical problems and federal funds were spent inappropriately. Similar issues were identified by BSA in their April 2006 Report #2005-120.

The organizational structure is the primary issue. The Commission has full accountability under federal law, yet, does not have full and direct authority for its administration of the FFEL Program under state law, because it must rely on an intermediary, the EdFund board, to implement the Commission's direction and objectives. The EdFund board, however, has been protected by the Department of Finance under SB 89. The current structure allows the EdFund executive management to be insulated from accountability for its actions such as spending state funds on inappropriate expenditures as identified in this report.

This is illustrated by past Finance actions. Based largely upon the previous BSA audits, the Commission attempted to exercise its full authority and responsibility for EdFund by clarifying its roles and responsibilities to ensure the Commission maintains its regulatory responsibility for financial aid program administration, policy leadership, program evaluation, and information development and coordination for the FFEL Program. (California Education Code 69522 (d)(1)(A)). Since June 2008 Commission staff has informed the Commission of numerous issues impacting effective Commission oversight and preservation of state funds including:

- EdFund's execution of a two-year contract for up to $93,000 to provide free coffee services to EdFund employees;
- EdFund's execution of a contract for up to $65,000 for creative design services to "rebrand" EdFund, despite the potential sale of EdFund;
- The EdFund board of Direcotr's use of state funds to hire the law firm of Nielsen, Merksamer, Parrinello, Mueller & Naylor to meet with Finance to

- The EdFund's President's authorization of a contract encumbering $5 million in state funds without review or consultation of either the EdFund Board of Directors or the Commission.
- EdFund's issuance of a Request for Proposal for Public Relations Services to Develop a Multimedia Public Awareness Campaign in violation of Commission policy.
- The need for amendments to the Commission's Executive Compensation Policy to prohibit the use of state funds for the payment of severance, retention or other bonuses payable to EdFund Executive Management.
- The expenditure of $1.3 million in state funds per year for an empty building leased by EdFund.

As a result of these and several other concerns establishing the need for the Commission to gain control over EdFund actions, the Commission removed the directors of the EdFund board and replaced them with the members of the Commission as authorized by the EdFund Bylaws. Finance immediately exercised its SB 89 authority by overturning the Commission's action and telling the EdFund board members to remain in place.

Finance indicated that it would audit inappropriate spending concerns and a number of other issues, including EdFund's proposed spending of $25,000 of state funds for an employee celebration event, and $2,000 to be used for a health fair to buy tote bags, an engraved i-pod, a gift certificate for an athletic shoe store, pizza, and massage therapy.

Finance's Office of State Audits and Evaluations unit reported in October 2008 to the Director of Finance that the free coffee for EdFund employees constituted an inappropriate gift of public funds. With respect to EdFund's proposed spending for the employee celebration event and the health fair, the Finance auditors told the Director of Finance that "it may indicate the need for an audit to determine whether other costs incurred by EdFund are unallowable under state and federal guidelines." Finance, however, did nothing to follow up on its own audit unit's warning. The Director of Finance stated in an October 21, 2008 letter to the then-Commission Chair that there was "nothing in the review that would change my previous decision to not approve actions…regarding the removal of the EdFund Board…."

Finance's assumption of full authority and responsibility for the FFEL Program has displaced the Commission's oversight and control, enabling EdFund to continue unallowable spending of state funds. EdFund states that Finance has not told them to stop unallowable spending identified by Commission staff. As BSA notes in this report, EdFund's chief financial officer explained that "other than the brief statement that it refrain from expending funds for employee celebrations and coffee services, EdFund did not receive a written or verbal directive from (sic) Finance to change its practices as a result of Finance's review."

EdFund did cancel the free coffee services to its employees in November 2008, and canceled the employee celebration event and the health fair. However, EdFund has failed to abide by Commission staff's continual direction to stop other inappropriate spending and gifts of public funds. EdFund continues its unallowable spending of state funds, in reliance on Finance's displacement of the Commission's oversight and control.

At the time EdFund was created in 1997, the Commission advanced $20 million into the Student Loan Operating Fund as operating capital for EdFund. EdFund uses this advance to pay its monthly operating expenses. The operating agreement between the Commission and EdFund establishes the reimbursement process. Specifically, the operating agreement requires EdFund to submit monthly invoices to Commission staff for review, authorization and reimbursement, from other state funds in the Student Loan Operating Fund, of EdFund's previous month expenses. EdFund expenses must adhere to Federal, State and Commission criteria in order to be reimbursed. Invoices must be consistent with Commission position and policies, allowable by federal regulations and cannot be a gift of state funds and cannot be a waste of public funds. Commission staff has refused to reimburse EdFund for improper expenses; however, since the operating capital in the Student Loan Operating Fund constitutes state funds, EdFund has already spent state funds and continues to spend state funds on items identified by Finance, BSA and the Commission as inappropriate.

EdFund reimbursement requests for the 2008-09 year include expenditures of state funds to buy gifts for EdFund employees, including gift certificates to movie theaters, gift cards for gasoline stations and Starbucks; refreshments and decorations for employee recognition events; and meals for EdFund board members and staff. Commission staff has refused to reimburse EdFund for over $300,000 in expenditures from May 2008 through September 2009 because EdFund has failed to establish that the spending does not constitute gifts of public funds, or has failed to provide adequate justification for spending state funds on lobbying, legal and consulting firms.

EdFund should not have the ability to spend state funds on $150-per-person dinners for EdFund staff or thousands of dollars for gift cards and staff recognition lunches for EdFund employees at any time, but especially in an environment of layoffs, furloughs, increased student fees in higher education, threats of cuts in health care for low-income people and in K-12 funding, and a $20-billion state budget deficit.

Commission staff continually directs EdFund to refrain from spending that constitutes gifts of public funds that violate state and federal law and violates Commission policies.
Rather than agreeing to end questionable spending of state funds, a member of EdFund executive management told Commission staff that the amounts are not material and EdFund will just write-off the expenses on its books if the Commission staff does not reimburse EdFund. At a recent public meeting, a member of the EdFund executive management indicated that EdFund would continue to use state

funds for meals served during EdFund executive management meetings because the meetings were important.

Finance's lack of action in the face of EdFund's questionable spending of state funds presents a stark contrast with its concern for other state funds. For example, a member of EdFund executive management has recently informed the Commission staff that Finance is aware of some of the expenditures Commission staff has refused to reimburse as unallowable expenditures, but has not directed EdFund to stop this type of spending.

Finance has pushed Commission staff to reimburse EdFund for $3.7 million in bonus payments even though EdFund has refused to provide Commission staff with necessary payroll audit documentation to justify the appropriateness of the payments. Finance has suggested that the Commission pay EdFund 90% of the $3.7 million until the appropriateness of the bonus payments is resolved. This is contrary to normal audit requirements and state procedures.

It should be pointed out that EdFund holds all its assets in trust for the Commission and the Commission owns all information in EdFund's possession. Thus, EdFund's refusal to give the Commission its own information, which the Commission needs to ensure that EdFund is appropriately spending state money, is unacceptable.

The Commission recently acted to reduce EdFund's proposed operating budget for 2009-10 from $92 million to $80 million. This represents a savings of state funds of $12 million. The reduction reflected the elimination of $3.6 million in bonus payments, $6 million in salary savings equivalent to the amount that would be saved if EdFund employees were on the same furlough schedule as other state employees paid with state funds, a virtual elimination of unidentified "contingency" expenses, and a 25% reduction in consulting and professional fees.

These reductions were consistent with the Governor's reductions for other programs and agencies. Finance overruled the Commission's reductions, allowing EdFund to continue spending state money based on the original proposed budget that was, by EdFund's own admission, merely a placeholder and incomplete. Finance explained its approval of the $12 million in increased EdFund spending with the argument that reductions in EdFund spending were premature in view of the uncertainty of the proposed federal law to eliminate the FFEL Program. However, by overruling the Commission's action, Finance has effectively relinquished state control over $92 million in state funds to a private organization.

Finance's casual treatment of those state funds again contrasts its actions in the 2008-09 Budget Act, when the Administration justified reducing the Commission's budget for oversight of EdFund, paid from the same state special fund used by EdFund, by 50%, or $500,000, as a way to "preserve resources," noting that "any savings that can be achieved in the Student Loan Operating Fund will result in the program being more valuable and thus result in additional General Fund revenue upon the sale, or other transaction, involving EdFund that is authorized by [SB 89]."

The BSA findings give weight to recent and increasing Commission, and Commission staff, concerns about whether EdFund's administration of the FFEL Program is, in fact, consistent with state and federal law.

Commission staff, and based on previous actions, in all probability, the Commission itself concurs with the findings and recommendations of the BSA. The Commission will be reviewing BSA's finding and the staff response at its next meeting.

Staff will recommend to the Commission to direct EdFund to modify its policies and procedures to comply with the BSA recommendations and recommend a corrective action plan to strengthen its reimbursement process and ensure that future Operating Fund expenditures are for only allowable activities and costs. The Commission believes it has both the authority and the statutory responsibility to review proprietary and confidential information related to EdFund's expenditures. However, EdFund does not agree. Commission staff will recommend to the Commission exploring all avenues to ensure it has access to all supporting documentation and the means to recover funds spent inappropriately. However, the Commission's authority to enforce the recommendations remains, for now, circumscribed by the veto power of the Department of Finance under SB 89.