



**JOHN CHIANG**  
**California State Controller**

August 27, 2010

Ana Matosantos, Director  
Department of Finance  
915 L Street  
Sacramento, CA 95814

Dear Ms. Matosantos:

At the request of the California Student Aid Commission (CSAC), the State Controller's Office (SCO) conducted an inquiry into CSAC's oversight and control over expenditures incurred by CSAC's auxiliary, EdFund. Under Government Code section 12410, the State Controller is responsible for ensuring the legality and propriety of state disbursements. EdFund's expenses are funded through the Student Loan Operating Fund (SLOF), which is comprised solely of state money.

Our inquiry has identified various oversight lapses and control deficiencies that raise serious concerns about the adequacy of the oversight and control over EdFund's expenditures. Chapter 182, Statutes of 2007, (SB 89) authorizes the Director of the Department of Finance (DOF) to take all actions necessary to preserve and maximize the value of the State's student loan guarantee program assets. Specifically, new Education Code section 69522 gives the DOF authority to veto CSAC actions to expand certain EdFund activities, and the revised Education Code section 69526 contains a list of EdFund expenditures that the DOF must approve, notwithstanding actions by CSAC.

We believe that the findings in the attached report could impact the DOF's responsibility under SB 89 to preserve and maximize the value of the EdFund. Therefore, we are bringing this matter to the attention of both your agency and CSAC. In doing so, it is our hope that the two agencies will work together to resolve the issues described in the report.

**CSAC/EdFund Financing**

CSAC has two funds maintained in the State Treasurer's Office (STO): the Student Loan Operating Fund (SLOF) and the Federal Student Loan Reserve Fund (Federal Fund). The SLOF is used to cover the expenses of the nonprofit auxiliary, EdFund. The Federal Fund is held in the STO and is the property of the United States government and is regulated by the Secretary of Education. The Federal Fund largely reflects transactions related to CSAC's student loan

insurance activity. These transactions include payments to lenders for defaulted loans. Revenue from the claim purchase complement of collection recoveries and the federal default fee are recognized in the Federal Fund. Generally, revenues from the Federal Family Education Loan (FFEL) Program are deposited into EdFund's bank accounts. EdFund then sends the revenues to CSAC's SLOF in the STO.

In 1997, legislation granted CSAC the authority to create a nonprofit auxiliary, EdFund, for the purpose of providing services related to CSAC's participation in the FFEL Program. When EdFund was created, a \$20 million advance was made from the SLOF (the original source was the State Guaranteed Student Loan Reserve Fund, which was subsequently divided into the current two funds). The advance was later recorded in the SLOF. The EdFund deposited the advance in a Working Capital account with the Bank of America. Generally, EdFund pays for its expenses from the Working Capital account and submits a request for reimbursement to CSAC.

The EdFund also has a second account—Equity Fund—of approximately \$25 million; this account was also established by an advance from the SLOF. This account was to be used for certain limited expenses (e.g., purchases of assets over \$5,000) which, as of 2007, must be approved by the DOF. Neither the Working Capital nor Equity Funds are maintained by the STO. The CSAC and EdFund have entered into an Operating Agreement that includes provisions governing the approval and payment of EdFund expenditures. The Operating Agreement includes two attachments covering the specific items of compensation and travel.

Under Section 6.4 of the Operating Agreement, expenditures from the Equity Fund must be agreed to by CSAC and the EdFund board and “in consultation with and approved by the California Department of Finance.” The most significant expenditure from the Equity Fund was a payment of \$6 million made to the Working Capital account to address cash flow issues which DOF approved in a letter dated September 16, 2008. However, the cash flow issues appear to have arisen as a result of CSAC's non-payment of certain expenditures related to a Default Payment Fee strategy that CSAC believed were unallowable.

### **Review Methodology**

As part of our inquiry, we reviewed reports issued by the Bureau of State Audits and the DOF's Office of State Audits and Evaluations (OSAE). We also reviewed the Operating Agreement between CSAC and EdFund. In addition, we reviewed CSAC's criteria for approval of expenses for invoices submitted by EdFund, as well as the provisions of the operating agreement between CSAC and EdFund, and CSAC's written policies and procedures governing contracting and travel expenses. In conducting the review, we interviewed CSAC staff members to identify the CSAC's processes and procedures to review invoices submitted by EdFund. Additionally, we selected a limited number of approved and disapproved transactions and traced them to available source documents to test the effectiveness of CSAC's expenditure review and approval process.

## **Findings**

*FINDING 1—CSAC has not taken action to preclude EdFund from continuing to incur in its Working Capital account expenses that have been deemed by the OSAE to be a waste or gift of public funds. In addition, these expenditures do not appear to be allowable under the Code of Federal Regulations, Title 34, Chapter VI, Part 682, Subpart D, Section 682.418.*

In its October 2008 report, OSAE found that EdFund's two-year contract of \$93,000 with Canteen Refreshment Services to provide coffee service for its employees constituted a gift of public funds. Subsequent to the OSAE report, EdFund continued the coffee service contract and paid Canteen Refreshment Services approximately \$9,000 through September 2009 from its Working Capital account, and then sought reimbursement from the SLOF. Although CSAC staff routinely rejected the reimbursement request, CSAC did not take further action to require EdFund to discontinue this inappropriate practice or recoup funds improperly spent. Because the Working Capital account was established with a \$20 million advance from the SLOF and receives reimbursements from the SLOF, it is subject to the same federal and state rules as is the SLOF. Thus, reimbursements that cannot be paid for from the SLOF also cannot be paid from the Working Capital account. EdFund's continued use of Working Capital account moneys to pay for employee coffee services, regardless of whether the moneys are reimbursed by the SLOF, still constitutes a gift of public funds unless the amount is recouped from EdFund officials or employees. Thus far, no money has been recouped.

In addition, EdFund has continued to engage in numerous employee-recognition events and activities that CSAC has deemed to be gift or waste of public funds. From September 2008 through September 2009, EdFund incurred \$11,380 in expenses for employee-recognition items and activities, such as gift cards for nail salons, Target, and Wal-Mart, and luncheons for all employees in the unit. While CSAC routinely rejected the reimbursement requests, EdFund continued to use its Working Capital account to pay for these events and activities.

Finally, CSAC has not reviewed EdFund's operation of the Working Capital account to ensure that EdFund is not paying for unallowable expenses and avoiding detection by not submitting claims for reimbursement. While CSAC does not believe that EdFund is engaging in this practice, it cannot verify that such activity is not occurring.

*FINDING 2—CSAC's claims invoice review criteria do not provide adequate guidance for an adequate review of EdFund claims.*

CSAC last updated its invoice criteria on July 20, 2009, to address concerns identified by OSAE in an October 2008 review report. The invoice criteria identified expenses specifically allowable under federal regulations, such as application processing, loan disbursement, and school and lender training. The invoice criteria also stipulates that expenditures cannot be a gift of state funds and cannot be a waste of public funds, and provided as examples employee coffee services, a rebranding contract, and other expenditures such as pizzas and gift certificates. However, CSAC has approved EdFund expenditures that appear inconsistent with its guidelines.

For example, on November 9, 2009, EdFund entered into a \$90,000 (\$10,000 monthly fee) sole-source contract with an individual, Esperanza Ross, for consulting services with regards to the future of EdFund. In accordance with CSAC's contracting policy, EdFund prepared a sole-source justification, which merely stated the contractor is "uniquely qualified to guide a thoughtful conversation on the short-term and long-term impacts of SB 89 and how the State of California can receive the maximum benefit in this uncertain economic environment." The justification had no explanation as to why the contractor's services were necessary and reasonable, what services were to be provided, or why the contractor is "uniquely qualified." Without this additional information, it would be difficult to evaluate whether the contract complies with the CSAC Invoice Criteria or constitutes a "gift or waste of public funds" as outlined in that criteria.

In addition, the Travel Policy in the Operating Agreement states that the EdFund will follow the per diem rates as published by the United States Internal Revenue Service (IRS) for meal and incidental expenses. However, CSAC staff members stated that they do not know or use the IRS per diem rate when reviewing and approving meal and incidental expenses. Instead, they assume that EdFund staff checked for compliance with their provisions of the Travel Policy before claims are submitted to CSAC. CSAC should, at a minimum, perform tests to ensure compliance with the policy.

*FINDING 3—CSAC is not reviewing travel expenses sufficiently to ensure that they comply with the provisions of the Operating Agreement or its own Invoice Criteria*

The Travel Policy in the Operating Agreement generally adopted the short-term travel policy of the State of California but also provides a process by which documented "exceptional circumstances" can be approved by the EdFund Chief Financial Officer and reimbursed through claims to the SLOF. However, CSAC staff review only a sample of travel reimbursement requests and generally rely on EdFund staff to ensure that claims are allowable. Such a practice can lead to unallowable reimbursement. For example:

- While the Travel Policy authorizes reimbursement for expenses incurred by its employees, board members, and contractors while traveling on behalf of EdFund, it does not contain a provision to allow for the payment of expenses of other individuals. However, EdFund executive staff members incurred meal expenses for non-EdFund employees and some claims have been reimbursed (see finding below on inconsistency). For example, the President of EdFund, Sam Kipp, claimed the following costs of meals during a trip to Washington D.C.:
  - \$711.64 (dinner for four EdFund staff members and five non-EdFund employees);
  - \$118.45 (lunch for three EdFund staff members and one non-EdFund employee); and
  - \$127.98 (lunch for three EdFund staff members and one non-EdFund employee).

In addition, the amounts incurred (approximately \$80 per person for dinner and \$40 per person for lunch) were excessive in comparison with state or IRS per diem rates. However, there was no evidence to support any variations from the Travel Policy for “exceptional circumstances” or that CSAC sought such evidence.

- We found no evidence that CSAC questioned employee expenses paid with American Express cards issued by EdFund. A limited review showed that some EdFund employees made trips to locations outside the mainland of the United States (Hawaii, Guam, Alaska, and Puerto Rico) using their American Express cards. While there may be legitimate business needs for such trips, the CSAC should make inquiries or request additional documentation for the credit card charges, at least on a sample basis, to ensure that internal controls at EdFund are functioning effectively.
- We noted one claim for an EdFund official who paid for meals for other EdFund employees, but there was no documentation to ensure that those employees did not also claim the cost themselves.
- For a conference that was held in January 2009 in Sacramento, California, \$36,672.66 was spent for room charges, catering services, and other charges. CSAC questioned the expenditures and then approved the reimbursement request after receiving an explanation that the charges were for the annual national sales meeting. A review of an itemized billing from the hotel showed individual room charges ranging from \$199.43 to \$366.91 for two nights. Food costs claimed per person, per day, were approximately \$70. Both of these amounts exceed those allowed by the Travel Policy attached to the Operating Agreement for attending in-state conferences. In addition, there was no indication that CSAC inquired whether the charges were for one person or multiple persons, one night or multiple nights, who occupied the rooms, or what the necessity of such expenditures were if the rooms were occupied by EdFund employees who live in Sacramento. In addition, there was no documentation to support more than \$17,000 in “catering charges” for this conference. Finally, there was no evidence that any of the costs were approved as “exceptional circumstances” by the EdFund Chief Financial Officer.

*FINDING 4—There appears to be a lack of consistency in some of the decisions reached by CSAC staff regarding reimbursements.*

For example, of the three meals paid by Mr. Kipp described above, CSAC rejected the dinner bill that totaled \$711.64 but approved the costs for the other two meals. In examining the supporting documents, we found the claim for the \$711.64 dinner bill actually contained an invoice detailing what was consumed during the dinner, (i.e., crab cakes, oysters on the half shell, rib eye steak, sea bass) while the two approved meals merely identified the attendees and the credit card receipt showing the total amount charged.

## **Recommendations**

The results of our review are consistent with the findings of the Bureau of State Audits (BSA) in its March 2010 audit report entitled "State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2009," and two review reports issued by DOF's Office of State Audits and Evaluations' (OSAE) in October 2008 and June 2010. Collectively, the findings of the various audit groups identified a persistent pattern of wasteful and potentially abusive spending practices by EdFund management even after they have been told that such practices were inappropriate. CSAC has been either unable or unwilling to take appropriate actions to ensure that expenditures by the EdFund are allowable under federal and state rules.

We understand the U.S. Department of Education has notified the State that it is terminating its agreement with CSAC by October 31, 2010, by transferring the federal guaranty designation to another entity. This effectively cancels the sale of California's student loan guaranty program assets and raises questions about the viability of EdFund to continue as a going-concern entity. Given the control deficiencies and oversight lapses identified by the BSA, the OSAE, and the SCO auditors, we believe it is imperative that the State take immediate action to safeguard and preserve state assets and ensure proper accountability if EdFund is soon to cease operation.

In light of the duties imposed on the DOF in SB 89, we are recommending that the DOF, in consultation with CSAC, take the following actions:

- Require EdFund to cease using its Working Capital account to pay for activities previously deemed unallowable.
- Develop and implement a plan to closely monitor EdFund's expenditures.
- Arrange for a comprehensive audit of EdFund expenditures for the past three years to ensure proper accountability over state funds. All of the audits/reviews conducted to date by the BSA, the OSAE, and the SCO auditors have been limited in scope.
- Require that EdFund provide a plan for how it will recoup unallowable expenditures already made, including the examples provided in this letter as well as any additional unallowable expenditures identified through the comprehensive audit.
- Require EdFund to provide sufficient, competent, and relevant documentation in support of expenditures. Specifically, EdFund should be required to provide documentation of any travel expenses that are approved under the exceptional circumstances provision in the Travel Policy attached to the Operating Agreement.
- Develop and implement a plan to conduct periodic field audits of EdFund's Working Capital account expenditures and internal controls if EdFund is to continue operation.

In addition, we suggest that DOF determine whether the \$6 million payment from the Equity Fund to the Working Capital fund was allowable. If it was not, then DOF should require that EdFund provide a plan for recoupment.

If you have any questions or need further assistance, please contact me at (916) 324-1696.

Sincerely,

*Original signed by*

JEFFREY V. BROWNFIELD  
Chief, Division of Audits

JVB/sk:wm

S10-SAA-900

cc: Barry Keene  
Chair, California Student Aid Commission  
Fred Klass, Chief Operating Officer  
California Department of Finance