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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

This letter report provides an update on recent events related to the Financial Information System for California (FI$Cal) project. Pursuant to Government Code, Section 15849.22(e), the State Auditor's Office (state auditor) is required to independently monitor the FI$Cal project throughout its development, as deemed appropriate by the state auditor. FI$Cal is a business transformation project for state government in the areas of budgeting, accounting, procurement, and cash management. The independent monitoring shall include, but is not limited to, monitoring the contracts for independent project oversight (IPO) and independent verification and validation (IV&V) services, assessing whether concerns about the project raised by the IPO and IV&V contractors are appropriately addressed by the FI$Cal steering committee and the FI$Cal project office within the Department of Finance or its successor entity, and assessing whether the FI$Cal project is progressing according to schedule and within budget. This is the sixth report we have issued since we began monitoring the FI$Cal project in 2007.

Government Code, Section 15849.22(e)(2), requires that the state auditor report on the status of the FI$Cal project at least annually before January 10. Accordingly, we are providing this summary of the events that have occurred since our last status update dated January 6, 2011. In that update report, we reported that the project awarded contracts to three "fit-gap" vendors—Accenture plc, CGI Group, Inc., and International Business Machines Corporation.[1] In addition, we provided updates on our oversight activities, the long-term funding options the project was considering, the project's difficulties in hiring and retaining staff, implementation of the project's new governance model, and trailer bill language to the Budget Act of 2010 that required the project to consider alternative approaches to implementation. Since that time, in April 2011, the project issued an addendum to its third Special Project Report (SPR) to modify its schedule to reflect the impact of factors, such as the former governor's August 2010 directive to cease hiring and the timing of the legislative review of the project's report to the Legislature. In July 2011 the project made further changes to its schedule to allow for additional preparation time for negotiations with the fit-gap vendors. The text box reflects the most recent scheduled completion dates for certain major milestones. As of December 2011 the project completed its negotiations with the three fit-gap vendors and is in the process of evaluating the

Completion Dates for Major Milestones

Milestone	Completion Date
Special Project Report	February 2012
Notice of Intent to Award	February 2012
System Integrator Contract Award	May 2012

Source: FI$Cal Weekly Project Status report, December 28, 2011.

1 "Fit-gap" is a process where vendors review the State's requirements for FI$Cal in detail and compare those requirements to the software products that they are proposing to generate a firm, fixed-price proposal.

vendors' final bids. This letter report provides updates on our oversight activities, the status of the project's long-term funding strategy, its continuing challenges in recruiting and retaining key staff, its slower than anticipated progress in performing data management and change management activities, and the importance of the project's upcoming fourth SPR.

State Auditor's Monitoring and Project Oversight Activities

As part of our monitoring activities, we continue to attend monthly oversight meetings, steering committee meetings, and steering committee executive working group meetings. As we pointed out in our October 2009 status update, the California Technology Agency (CTA)[2] assumed the responsibility of contracting for a consultant to perform the IV&V services for the FI$Cal project and engaged Eclipse Solutions for this purpose. Although its contract with Eclipse Solutions was to end on January 2, 2012, the CTA extended this contract through January 2, 2013.

In our last three status updates, we communicated a concern about the CTA's plan to provide the IPO services for the project even though the Secretary of the California Technology Agency (technology secretary) serves as a voting member of the project's steering committee. We are concerned that this arrangement—the CTA providing the IPO services and the technology secretary being a voting member of the steering committee—might, either in fact or appearance, create a conflict that undermines the purpose of the IPO, which is to provide an independent, unbiased perspective. As of this date, we have identified no actual conflicts or compromises in the integrity of the IPO services, despite our ongoing concern. Moreover, CTA's staff person assigned to perform IPO services is excluded from the steering committee executive working group meetings that the project established in October 2010 as part of its new governance model, which we discussed in greater detail in our last report. We believe that the IPO staff person should participate in these meetings so that the flow of communication and the process of governance could be observed. We communicated our concern to the project and the CTA. According to the technology secretary, the staff person obtains information about governance decisions through daily engagement with project staff and attendance at the steering committee meetings, which includes the same issues discussed during the steering committee executive working group meetings, but to a broader audience. Further, the technology secretary indicated that these meetings include discussion of project staff performance that would not be appropriate for the staff person to observe. Finally, the technology secretary told us that he consulted with the other members of the steering committee executive working group and they believe that the IPO staff person should not be attending these meetings for the same reasons. Nevertheless, without attending these meetings, we believe the ability of the CTA staff person acting as the IPO to assess the group dynamics and whether decisions communicated to project staff and during the quarterly steering committee meetings are in the context of the working group discussions may be impaired.

The IPO and IV&V track and regularly report on the issues relating to FI$Cal.[3] Using this information and similar information reported by the project, we determined that the FI$Cal project is not promptly resolving many of the issues identified as needing attention. Specifically, as of January 2011 the project reported nine issues that were outstanding beyond 90 days, four of which the project considers "high priority." However, by November 2011 the project's efforts to resolve these issues had worsened

2 Prior to 2011 the CTA was called the Office of the State Chief Information Officer and the technology secretary was called the State Chief Information Officer.

3 According to the CTA's *Project Management Methodology Reference Manual*, "issues" are unanswered questions and differences of opinion.

because, as of that time, the project reported 15 issues that were outstanding beyond 90 days, five of which are high priority and include two of the same issues that were reported in January 2011. All of the high-priority issues are related to project staffing and data management, which we discuss later in the report. If such a trend persists when the project enters the development phase, there is an increased likelihood that these unresolved issues will cause delays for the project. To address this problem, the project indicated that in September 2011 it hired a manager to address outstanding risks and issues. Although we believe this is a positive step, as of the public date of this report, significant risks and issues, such as attracting and retaining qualified staff, remain unresolved. In the following sections, we discuss the challenges and issues that we believe will have the largest impact on the project. One such challenge, which the project has not identified as a risk or issue in recent months, but that we believe is significant, is the uncertainty surrounding the project's long-term funding.

The Project Plans to Propose Its Long-Term Funding Options Soon, but Significant Challenges Remain

In our last three status updates, we reported the fact that the FI$Cal project lost its source of long-term funding and that it was exploring various other funding options. In its second SPR issued in November 2007, the cost of the project was estimated to be approximately $1.6 billion spread over 12 years. The project did not update this estimate in its third SPR released in November 2009. Instead, according to the third SPR, the project planned to re-estimate its overall costs and address its long-term funding and financing plans in the fourth SPR. As we discussed previously, the FI$Cal project intends to release its fourth SPR in February 2012 and, at the same time, submit a written report to the Legislature on its selection of the winning system integrator before it awards the contract, as required by law.

To fund its costs for fiscal year 2010–11, the project reported using some of the remaining loan balance it received in fiscal year 2008–09 and a combination of appropriations from the State's General Fund and various special revenue and nongovernmental cost funds. For fiscal year 2011–12, the project has an appropriation of $38.5 million, which includes the costs associated with the three vendors to complete the fit-gap analysis. It received an appropriation of $2.5 million from the General Fund, $6.3 million from the Central Service Cost Recovery Fund, $4.5 million from the FI$Cal Internal Services Fund, and $25.2 million from various special and nongovernmental cost funds to support the remaining expenditures.[4] As of November 2011 the project reported $62.6 million in total project expenditures and, according to the project executive, the project estimates it will spend $32 million of its $38.5 million appropriation it received for fiscal year 2011–12.

As we explained in greater detail in our October 2009 status update, originally, trailer bill language to the Budget Act of 2008 allowed FI$Cal to sell bonds to finance the project. However, the FI$Cal project indicated that because of the State's economic situation and a law that prohibits the use of bonds to finance a budget deficit, it determined that it could not rely on the sale of bonds to fund the project as it had initially planned. Since our last update, the project has narrowed its funding options to pay for project development to three. The Table on the following page summarizes the project's analysis of the significant advantages and disadvantages of each funding option. According to the project, the funding plan it ultimately selects could include some combination of these options. However, until the project completes its fourth SPR, the total cost of the project and the long-term funding solution remain uncertain.

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[4] The Central Service Cost Recovery Fund provides money for the administration of state government, as determined by the director of the Department of Finance.

Table

Financial Information System for California's Long-Term Funding Options for Project Development Costs

OPTION	ADVANTAGE	DISADVANTAGE
Pay-as-you-go cash payments from the State's General Fund and special funds	This is likely the least expensive option because it avoids interest costs that would be incurred in the two financing options listed.	This option would require the project to pay costs as they are incurred during the design, development, and implementation phase rather than allocating costs over the period that the project's benefits occur as would be the case using one of the financing options below. Because of California's current economic challenges, the Legislature and governor would need to make difficult decisions about how to fund FI$Cal development with the least impact on services that the General Fund and special funds provide.
California Infrastructure and Economic Development Bank (I-Bank)* bond issuance	This option would allow the project to spread out its cost over time to better match the expected life of the system.	The project believes this option is complex and would require legislation to authorize the I-Bank to issue bonds for a state project. This option is more expensive than pay-as-you-go because the project would incur bond issuance costs as well as financing costs.
Vendor financing	The project believes that this option is less complicated than funding through I-Bank because it does not involve the legal complexities of a bond offering. Additionally, the project would not incur bond issuance costs.	Vendor financing is at the discretion of the vendor. Further, the project believes a vendor may limit the types of costs it will be willing to finance and that vendor financing is likely to be shorter term than a bond issuance.

Source: A Financing and Funding Framework for the Financial Information System for California (FI$Cal), April 2011.

* The California Infrastructure and Economic Development Bank has broad authority to issue tax-exempt and taxable revenue bonds on behalf of private enterprises and local public agencies.

The Project Continues to Experience Staffing Difficulties

As was also mentioned in our last three status updates, because of the uncertainty surrounding its future funding, we are concerned that the FI$Cal project may have difficulty attracting and retaining qualified staff. In September 2011 the IPO staff reported that the Department of Finance removed the restrictions of the governor's hiring freeze that previously constrained the number of employees the project could hire. Despite this action, the project's full-time position vacancy rate remains high. As of December 2011, 52 out of a total of 161 full-time budgeted positions (32 percent) were vacant. However, it is important to note that 17 positions were filled since September 2011. These figures are a modest improvement to those we previously reported for December 2010. At that time 75 out of a total of 165 full-time budgeted positions (45 percent) were vacant. If not addressed soon, these vacancies could prove to be problematic for the project going forward as it will have to hire and assimilate a large number of staff into the project in a short period of time after the vendor contract is awarded, increasing the risk that the project could encounter delays.

Additionally, the project's oversight entities have expressed concern that FI$Cal is not adding qualified staff quickly enough to handle the work that it could be performing in preparation for its contract award date, estimated to be in May 2012. The IPO staff recently communicated that the project's most significant issue is staffing in terms of both quantity and skill set. Moreover, according to the IV&V consultant, the State has limited resources available with the specialized skills and experience that FI$Cal—the State's largest and most challenging business transformation project—requires. The IV&V consultant also reported that although FI$Cal continues to work within the State's human resources policies, there may be long-term effects if FI$Cal does not get relief from policies that work to the project's disadvantage. Specifically, the IV&V consultant believes that the State Restriction of Appointment (SROA) process will be a continuing impediment to filling many of the FI$Cal positions that require specialized skills and experience, and has recommended that the project pursue a blanket exemption from this process. However, the project indicated that it can only ask for exemptions on a position-by-position basis.

The project indicated that it has been attempting to mitigate the lack of staff through the use of consultants. For instance, the project has been using a consultant to assist with project management, an area where the project and the IPO staff have reported a lack of qualified staff. In an attempt to further supplement areas where expertise is lacking, the project plans to borrow staff from state departments through interagency agreements. However, the project acknowledges that this will be a challenge since departments have competing priorities over how to allocate their staff.

Financial Information System for California Management Positions Experiencing Turnover Between September 2010 and December 2011

- Project Sponsor
- Project Executive
- Project Director
- Deputy of Administration
- Deputy of Business Team
- Deputy of Change Management
- Deputy of Project Management
- Chief Information Officer

Sources: Bureau of State Audits' analysis of independent project oversight reports, project status reports and meeting minutes, and discussions with project management.

Furthermore, the project has continued to experience turnover in the eight key management positions, as shown in the text box. As previously reported, the FI$Cal project director, project executive, and deputy director of project management resigned in late 2010. Following these resignations, the project filled the deputy director of project management position with the former IPO staff and combined the project executive and project director positions into one project director position, which it filled in February 2011. However, in August 2011, at the IPO's suggestion, the project once again separated this position into a project director position and a project executive position, which the project filled in November 2011. A month later, in December 2011, the project executive resigned after holding the position for slightly less than 12 months. The project recently issued an exam bulletin in order to fill this position. Additionally, during 2011, FI$Cal experienced turnover in the other five key management positions. Although the project was able to subsequently fill these positions, the turnover of the day-to-day leadership in such a short period of time poses challenges to maintaining the continuity and consistency of the vision and the execution of the project. The project indicates that the demands of serving on a large, highly complex project can be exceptionally challenging and it is not uncommon for projects to consistently experience higher turnover than in other program areas, including in executive positions, but it also recognizes that the high turnover in key management positions could give the perception that the project is troubled, further complicating recruitment and retention efforts. The project stated that it is leveraging the experience of key project staff members to maintain progress.

The Project's Data Management and Change Management Efforts are Progressing Slower Than Anticipated

The project's staffing challenges have slowed progress toward completing two critical activities—data management and organizational change management. According to the IV&V consultant, data management is a large component of the FI$Cal project and one that has suffered as a result of resource constraints. Data management encompasses creating an inventory of data to be converted, preparing the data for conversion, and then converting the data to the new FI$Cal system. The IV&V consultant also reported that a significant set of the data management activities are the responsibility of the State, including creating the data inventory and preliminary cleansing of the data, and are precursors to the work that the system integrator will perform. The IPO staff has also reported data management as a high priority issue for the project. As such, the project is seeking to hire additional employees and has planned to obtain the services of a data management contractor to assist with the conversion preparation. However, in June 2011, the project cancelled the procurement of the data management contractor because it considered the bids to be inadequate. As of November 2011 the project indicated that it has drafted a request for offers for a data management contractor and will be attempting to hire one. We are concerned that if the project does not complete activities that are required to be completed prior to when the system integrator begins its work, the project could face delays.

Similarly, the project's organizational change management efforts are also experiencing staffing challenges and are progressing slower than anticipated. The project's change management office is responsible for preparing each state department for the changes necessary to successfully integrate with FI$Cal and to develop an infrastructure that facilitates ongoing communications and activities between FI$Cal and state departments. The project indicated that it is seeking to hire additional employees and is considering hiring a change management contractor in this area as well. The IV&V consultant reported that the project held a department liaison network kick-off meeting in November 2011 for representatives from all FI$Cal-participating agencies and departments. The IV&V consultant stated that it continues to encourage the project to initiate discussions with departments about the need to appoint some of their staff to act as sponsors of FI$Cal. The IV&V consultant cautioned that without these sponsors to support and provide consistent communication concerning FI$Cal's business transformation, the organizational change management challenges that departments could face might prove to be FI$Cal's largest impediment to success.

The Project's Fourth Special Project Report, Due by February 2012, Will Include Important Information

To date, the project has shown substantial progress in its procurement efforts to obtain a systems integrator despite the challenges previously discussed, but the future success of the project is dependent upon some key factors that will be revealed in the coming months. Although the fourth SPR was not available for our review at the time of this report, it is expected to include vital information such as updates of the estimates of the total cost of the project, its implementation schedule, staffing plan, and the project's proposed source(s) of funding and financing plan along with a cost-benefit analysis. In addition, the project's fourth SPR is expected to include a baseline of performance metrics that it will use to measure the effectiveness of FI$Cal once the project is implemented. Along with the fourth SPR, the project will announce which bidder it has selected as its systems integrator. We believe that the information the project presents in the SPR and the accompanying legislative report due in February 2012, will be critical as the Legislature determines how the project should move forward.

We will continue to monitor and report on these topics in addition to others that come to our attention, at a minimum, before January 10 each year.

Respectfully submitted,

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