

April 26, 2012

2012-039

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 California State Auditor (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 timely and within budget. We are required to report on the project's status at least annually and this is the seventh report we have issued since we began our monitoring in April 2007.

The project released its fourth Special Project Report (SPR) on March 1, 2012, to update information in prior SPRs regarding FI\$Cal's costs, schedule, benefits, and cost savings, and to announce that the project is ready for implementation. The project also announced that Accenture plc was the project's winning fit-gap vendor¹ and is its selected systems integrator, with a proposed five-year contract for \$213.1 million. Statute requires the project to submit a report to the Legislature with specified information about the selected system integrator and alternative implementation approaches, 90 days before entering a contract with the system integrator. The project submitted the FI\$Cal legislative report on March 2, 2012. The remainder of this letter report provides our review of selected information in the fourth SPR, including FI\$Cal's updated cost estimates and proposed funding option, projected benefits, revised project schedule and implementation approach, and envisioned risks and assumptions. This letter report also provides status updates on topics that we have previously reported on.

The Project Reports a Significant Reduction in Costs and Proposes a Pay-As-You-Go Funding Plan

In the project's second SPR issued in November 2007, the cost of FI\$Cal was estimated to be approximately \$1.6 billion spread over 12 years.² The fourth SPR revises the estimated cost of the project downward to \$616.8 million. Table 1 on the following page shows the change in estimated costs between the second and fourth SPRs among major categories.

¹ The other "fit-gap" vendors were CGI Group, Inc. and International Business Machines Corporation. "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.

² The project did not update the second SPR's estimate of costs in the third SPR, which it released in November 2009.

Table 1
Comparison of FI\$Cal Costs Per Special Project Reports 2 and 4
(In Millions)

COST CATEGORY	SPECIAL PROJECT REPORT 2	SPECIAL PROJECT REPORT 4	DIFFERENCE
Staff			
Project staff	\$287.7	\$209.2	\$(78.5)
Program staff	264.4	-	(264.4)
Administrative staff	29.1	-	(29.1)
Total Staff Costs	581.2	209.2	(372.0)
Hardware, Software, and Telecommunications	156.7	19.1	(137.6)
Contract Services			
Contract services—system integrator	372.2	199.3*	(172.9)
Other contract services	59.8	100.2	40.4
Total contract services	432.0	299.5	(132.5)
Data Center Services	298.8	19.0	(279.8)
Agency Facilities	69.9	21.0	(48.9)
Other Costs	81.5	49.0	(32.5)
Total Project Costs	\$1,620.1	\$616.8	\$(1,003.3)

Sources: FI\$Cal Special Project Report 2, released November 9, 2007, and FI\$Cal Special Project Report 4, released March 1, 2012.

* The total system integrator costs, as presented on page 1, are \$213.1 million. The \$199.3 million represents a large portion of the system integrator costs, but another \$13.8 million of system integrator costs are included in the Other Contract Services line item.

As shown in Table 1, the four largest cost changes are in the categories of project and program staff; contract services; hardware, software, and telecommunications; and data center services. For project staff, which are the staff directly assigned to the FI\$Cal project team, the project reduced its estimate of staff needed during the project’s peak activity from 499 to 304 primarily because the project’s implementation period was reduced by two years, which results in a cost reduction of \$78.5 million. For program staff—state department staff that the project plans to engage during implementation—the project has transitioned to a “subject matter expert” model whereby department staff will be engaged on a part-time basis as needed, rather than as full-time staff dedicated to the project, as it had previously planned. The project believes that it would have been difficult for departments to assign full-time staff to the project and that this model is a more efficient use of state staff resources. Moreover, if the project chose to reimburse departments for program staff, the project believes that the cost allocation plan it intends to use could create the potential for departments to subsidize each others’ staff costs during the implementation phase. Because of the reasons described, the project is no longer planning to provide reimbursement to any program staff, and therefore such costs are not included in the total cost of the project. However, by not requiring departments to track and report the cost of subject matter expert staff, the project will underreport FI\$Cal’s true cost. This cost could be significant as it was estimated at \$264.4 million in the second SPR. We believe it is feasible that each department could establish a new program cost accounting code to track its staff’s time spent on FI\$Cal-related activities and report these costs to the project.

Additionally, the project reports reducing the cost for contract services by \$172.9 million because the fit-gap process allowed bidders to better understand FI\$Cal’s areas of complexity and risk. Thus, the project believes that bidders were able to reduce the “risk premium” usually associated with large information technology projects. Likewise, through discussions with the California Technology Agency (CTA) and with the bidders about FI\$Cal’s data center requirements, the project indicates being able to reduce the estimated cost for data center support by \$279.8 million. The project’s costs for hardware, software, and telecommunications were similarly reduced by \$137.6 million, with the largest reduction attributable to software costs. According to the project, the reduction in software costs is due to reducing the estimated number of FI\$Cal users by about two-thirds, negotiating lower license costs due to the fit-gap procurement, and decreasing software maintenance costs because the estimated implementation timeline was shortened from seven to five years.

Table 2
FI\$Cal Funding Options
 (In Millions)

OPTION	DETAILS	INTEREST*	PROJECT IMPLEMENTATION COST
Pay-As-You-Go	FI\$Cal would receive an annual appropriation to fund implementation cost.	\$0	\$522.2
Vendor Financing	The system integrator would allow FI\$Cal to finance the cost of its contract (about one-third of the total cost). [†]	73.2	595.4
Bond Financing	Issuance of tax-exempt bonds to finance cost of the system integrator contract and state staff (about one-half of the total cost). [†]	68.9	591.1

Source: FI\$Cal’s Special Project Report 4, March 1, 2012.

* FI\$Cal estimates interest rates of 5 percent for vendor financing and 4.25 percent for bond financing.

[†] Remaining costs would be funded by an annual appropriation.

To pay for the project’s one-time system implementation costs, FI\$Cal presents three funding options as shown in Table 2, along with the associated project and interest costs. FI\$Cal indicates that the State’s General Fund (general fund), special funds, and the federal fund will pay for FI\$Cal’s development costs, at an estimated split of 47.11 percent, 39.90 percent, and 12.99 percent, respectively, but the general fund would need to pay the federal fund’s share until the project is successfully implemented. The project recommends pay-as-you-go as the preferred funding method citing that this method avoids interest costs, does not add to the State’s annual debt service costs, and would allow the Legislature to modify the project’s funding, if necessary, without the risk of damaging the State’s credit rating. The fourth SPR indicates that both vendor and bond financing are more expensive due to interest costs, which would be ineligible for federal reimbursement. Further, the project indicates that neither of these methods would allow financing of the full project cost as shown in Table 2 above. In both financing methods, if the State were to delay or halt the project and not appropriate funds for its financing, the project believes there is risk that such an action could create a perception of a default on the financing by the investor community, which in turn would negatively impact the State’s credit rating. Finally, the project notes that legislation would be needed to provide it authority to use vendor financing.

The Project Cites Significant Potential Benefits From Implementing FI\$Cal

FI\$Cal's fourth SPR also includes an estimate of expected benefits the State would achieve from FI\$Cal based on a benchmarking study completed by The Hackett Group (Hackett) in October 2011. Hackett's study predicts that the project's cumulative expenditures will be offset by its benefits by fiscal year 2017–18 and that during each fiscal year thereafter, benefits will exceed annual maintenance costs for the system. By fiscal year 2020–21, Hackett estimates quantifiable annual benefits will stabilize at \$414.6 million from three main areas. The first area is process cost savings, with projected annual savings of \$173.2 million that would result from efficiency and productivity improvements to processes within the scope of the FI\$Cal project. The project indicates this savings mostly results from a reduction of labor costs through staff attrition and staff redeployment to other process areas. The second area is technology and other cost savings, with projected annual savings of \$28 million achievable through the retirement of existing systems that FI\$Cal will replace. The third area is procurement effectiveness improvement, with projected annual cost avoidance of \$213.4 million realizable through better management of statewide procurement activities and the ability to increase strategic sourcing, such as selecting best performing suppliers and having a higher purchase volume per supplier on better terms.

In regards to nonquantifiable benefits, Hackett notes that FI\$Cal will replace many state legacy systems that are poorly documented, are difficult to maintain or are outdated, or are running on technology platforms that are no longer supported by vendors. Another nonquantifiable benefit that Hackett identified is that the State could develop and use improved budgeting and planning processes to allow for more effective allocation of resources.

We did not analyze these benefits, but our information technology expert (IT expert) indicates that Hackett is a reputable organization. Hackett indicates its benefit analysis presumes that the State is able to realize economies of scale relative to other states³ in the benchmark peer group and that by implementing FI\$Cal the State will be able to execute a comprehensive transformation program in terms of process redesign, technology enablement, and data standardization. If the State is unable to meet these assumptions, our IT expert indicates that the actual benefits realized may be less than Hackett projected.

The Project's Revised Schedule and Implementation Approach

The fourth SPR provides updates on the project's schedule, provides details on its implementation approach, and notes there have been no changes to the project's scope from what the project reported in the second SPR. The project now believes that implementation will take only five years instead of the seven years that was anticipated in the second SPR, but because it spent two years on the fit-gap procurement, the anticipated date for the project's implementation remains July 2016. In the fourth SPR, FI\$Cal's revised implementation approach is comprised of five waves: a pre-wave followed by four implementation waves. The pre-wave will be limited to the Department of Finance, the Department of General Services, the State Controller's Office, and other select departments for limited elements of FI\$Cal. As the project progresses through the waves, it plans to increase the number of state departments participating in FI\$Cal as well as introduce additional pieces of system functionality. The project has identified 16 departments with special statutory or constitutional provisions that either exempt them from using FI\$Cal or that are allowed to defer use of FI\$Cal to a later date because they

³ The benchmark peer group of states referred to in the Hackett Group study is comprised of Tennessee, Ohio, Alabama, Arizona, Colorado, Delaware, West Virginia, Oklahoma, Georgia, New Jersey, Massachusetts, and Mississippi.

recently implemented or are implementing a financial management enterprise resource planning system. Despite these departments' special circumstances, all must exchange information necessary for the State to perform processes relating to the independent audits of receipt or disbursement of funds, warrant issuance, budgeting, and financial reporting.

Project Assumptions and Risks

FI\$Cal also presents its assumptions in the fourth SPR as summarized in the textbox. Key assumptions include that FI\$Cal will be able to recruit the staffing needed for its project team, which has been a challenge for the project but that it believes will be significantly reduced when the project obtains a stable source of funding. Another key assumption is that the State minimizes the customization to the software that the system integrator will provide. The project has decided to use a commercial-off-the-shelf software package with minimal modifications, but our IT expert indicates that any significant modifications added during implementation could increase project and ongoing costs, as well as increase the implementation time.

Further, we reviewed the project's list of risks included in the fourth SPR, and it appears that at this time the project has assessed its risks realistically. In fact, the list includes project funding as a risk, which resolves a concern we raised in our January 2012 report that the project was not reporting project funding as a risk or issue. Other FI\$Cal risks include issues we have previously reported: staffing challenges, change management, data management, and project governance.

Updates on Previously Reported Topics

In our January 2012 status update, we provided updates on our oversight activities, the project's long-term funding strategy, continuing challenges in recruiting and retaining key staff, slower than anticipated progress in performing data management and change management activities, and the importance of the project's upcoming fourth SPR. At this time, we believe it is appropriate to provide brief updates on some of those topics. In our last four 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 CTA (technology secretary) serves as a voting member of

FI\$Cal Assumptions

- Adequate project funding is available throughout the project lifecycle.
- Accenture plc will fulfill its contractual obligations.
- Accenture plc has provided a comprehensive firm, fixed price bid based on its in-depth understanding of the State's needs and requirements gained through the fit-gap and negotiation process.
- Departments and control agencies will fully participate in the design, development, and implementation of FI\$Cal by participating in business process reengineering, making timely decisions and actions, and providing highly qualified collaborative staff that are empowered to make decisions and perform activities on behalf of their departments.
- The State will operate existing systems in conjunction with FI\$Cal as necessary, which will require temporary interfaces, until existing systems are phased out.
- The existing information technology infrastructure at state agencies is sufficient to support FI\$Cal.
- FI\$Cal will be able to obtain employee position data from current and future systems of the State Controller's Office.
- State agencies and departments, including exempt and deferred departments, will participate and provide information as required to successfully develop and implement system interfaces and data exchange processes.
- FI\$Cal will be able to recruit and retain a workforce with the necessary skills, knowledge, and experience to implement, operate, and maintain the selected system consistent with the project schedule and defined roles and responsibilities.
- The State will minimize system customizations to preserve the flexibility and ability to maintain and upgrade FI\$Cal.

Source: FI\$Cal's Special Project Report 4, March 1, 2012.
The information in this textbox is a summary of FI\$Cal's table of assumptions presented in that report.

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. In March 2012 the CTA made a request to the project to make the technology secretary a nonvoting member of the steering committee. The project expects the CTA's request will be approved at the next steering committee meeting, which is scheduled for June 2012.

Additionally, by fall 2012, CTA plans to transition the IPO role to a private contractor. As previously reported, we believe that such an action would help assure that project oversight is unbiased and independent. To help assure that project oversight is unbiased, independent, and effective, we believe that IPO and IV&V services should be performed by different vendors. This allows the IPO vendor to objectively evaluate the performance of the IV&V vendor and to assess the project's response to the IV&V vendor's findings and recommendations. Further, because the contract for the current IV&V vendor will conclude by the end of fiscal year 2012–13, CTA plans to procure the services of another IV&V vendor in early fiscal year 2012–13. In regards to project staffing, the vacancy rate remains near the levels we reported in January 2012. As of March 31, 2012, the IPO reports that 47 of the project's 156 full-time budgeted positions (30 percent) were vacant. Furthermore, the project continues to experience turnover in key management positions, with the February 2012 departures of the individuals holding the deputy director positions of change management and project management. The project filled the position of the deputy director of change management in April 2012.

Recommendations

If the Legislature decides to approve funding for the FI\$Cal project, it should consider the following recommendations:

- To ensure that the cost to implement FI\$Cal accurately reflects the effort needed, the Legislature should require the project to track the cost of department subject matter expert staff and include this cost in the total cost for FI\$Cal.
- To monitor the benefits that FI\$Cal is projected to provide based on the Hackett study, the Legislature should require the project to track projected benefits as they are achieved and to report annually on the total benefits achieved, any changes in total projected benefits, and actual and project benefits as compared to actual and projected FI\$Cal costs.
- The Legislature should require the project to report annually on the cost and reasons for any significant customizations it makes to the software that were not anticipated at the onset of FI\$Cal implementation.

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,



ELAINE M. HOWLE, CPA
State Auditor