

California State Auditor

B U R E A U O F S T A T E A U D I T S

Investigative Report:

**Conflicts of Interest and Mismanagement
of Federal and State Funds at the
California Student Aid Commission**



March 1998
Report I960207

The first printed copy of each California State Auditor report is free.

Additional copies are \$3 each.

Printed copies of this report can be obtained by contacting:

**California State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814
(916)445-0255 or TDD (916)445-0255 x 248**

Permission is granted to reproduce reports.



CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

March 31, 1998

Investigative Report 1960207

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

Dear Governor and Legislative Leaders:

Pursuant to the Reporting of Improper Governmental Activities Act, the Bureau of State Audits presents its investigative report concerning the California Student Aid Commission (CSAC). This report concludes that the CSAC's system for administering the Federal Family Education Loan Program creates both legal and ethical problems, including conflicts of interest. In addition, the CSAC does not ensure that federal funds are spent appropriately. Finally, the CSAC paid an improper salary advance to an executive.

Respectfully submitted,

A handwritten signature in black ink that reads "Kurt R. Sjoberg". The signature is written in a cursive style with a large, prominent "K" and "S".

KURT R. SJOBERG
State Auditor

Table of Contents

<i>Summary</i>	<i>S-1</i>
<i>Introduction</i>	<i>1</i>
<i>Chapter 1</i>	
The California Student Aid Commission's System for Administering the Federal Family Education Loan Program Creates Both Legal and Ethical Problems	<i>5</i>
<i>Chapter 2</i>	
The California Student Aid Commission Does Not Ensure That Federal Funds Are Spent Appropriately	<i>11</i>
<i>Chapter 3</i>	
The California Student Aid Commission Paid an Improper Salary Advance	<i>21</i>
<i>Conclusion</i>	<i>23</i>
<i>Agency Response</i>	<i>25</i>

Summary

The California Student Aid Commission (CSAC) oversees the Federal Family Education Loan Program (FFELP) in California. In fiscal year 1996-97, California received \$331 million in federal funds for this program, moneys that are predicated on CSAC's compliance with federal requirements. The members of the CSAC's governing commission also have a responsibility to the governor and legislative leaders who appoint them to ensure that funds are spent properly and economically.

We received an allegation under the Reporting of Improper Governmental Activities Act that an official of the CSAC is improperly employed at the EdFund—a nonprofit corporation established to assist the CSAC in its administration of the FFELP. The complainant also alleged that the official is improperly receiving compensation from the EdFund. Finally, the CSAC allegedly made an improper loan to the official.

We investigated and substantiated these and other improper activities. Specifically, we found the following:

- By allowing an executive to also work at the EdFund, the CSAC causes a conflict of interest and creates an inadequate separation of duties.
- The CSAC permitted the EdFund to pay the executive \$40,000 for services he had already been compensated for to avoid an impending federal cap on his salary.
- The CSAC does not spend federal funds economically. During calendar year 1997, taxpayers paid the executive approximately \$199,693 in salary and bonuses—\$91,000 over his state-approved salary.
- Because the CSAC has transferred many of its legal and administrative personnel to the EdFund, it is not able to protect public funds entrusted to it.
- Because the CSAC has inadequate controls over payments to the EdFund, it made a duplicate payment of approximately \$1 million to the EdFund in 1997.

- The CSAC's lack of administrative controls allowed an employee to make a salary advance of \$28,647 to the executive without authority to do so or confirmation that the executive was entitled to it. Although the executive repaid this advance within 17 days, this advance was, in effect, an interest-free loan.

Agency Response

Because the governor appoints most of the 15 members of the commission, we sent our report to the Governor's Office for response. The Governor's Office strongly disagrees with our interpretation of the various laws cited in the report and does not believe that the executive's dual employment violates the law. Nevertheless, it has recommended that the commission end the executive's dual employment and that the executive devote all of his energies to the EdFund. The commission accepted the executive's resignation from his CSAC position, effective March 16, 1998.

Introduction

The Bureau of State Audits executes the provisions of the Reporting of Improper Governmental Activities Act (act), which is contained in Section 8547 et seq. of the California Government Code. The act defines an improper governmental activity as any activity by a state agency or employee during official duties that violates any law or regulation; is economically wasteful; or involves gross misconduct, incompetence, or inefficiency.


Whistleblower hotline:
(800) 952-5665


To enable state employees and the public to report improper governmental activities, the Bureau of State Audits maintains a toll-free whistleblower hotline at (800) 952-5665 and investigates these complaints.

Background

The California Student Aid Commission (CSAC) administers federal and state financial aid programs, including grants, scholarships, work study, and loan programs for students attending California's postsecondary schools. The CSAC is governed by 15 commission members who select a new chairperson each year.¹

Effective July 1995, the commission hired an executive to administer state and federal scholarship, loan, and grant programs; manage staff; and advocate on behalf of the CSAC before state and federal agencies. This executive was instrumental in advocating for the creation of the EdFund, a nonprofit organization to improve the commission's ability to compete with other entities to provide California students with faster, easier, and less costly student loans.

In September 1996, the California Education Code was amended to authorize the CSAC to establish the EdFund as a nonprofit public benefit corporation. This auxiliary organization was incorporated in January 1997. The EdFund contracts to assist the CSAC in operating the Federal Family Education Loan Program (FFELP). The CSAC is responsible for financial aid program administration and evaluation,

¹ Throughout this report, we refer to the organization as "the CSAC;" we refer to the group of governing commissioners as the "commission."

information development and coordination, and accountability to the federal government. Prior to 1997, it directly operated this federal program, which represented 85 percent of its workload. During fiscal year 1995-96, the CSAC guaranteed approximately 362,000 new loans totaling \$1.535 billion.

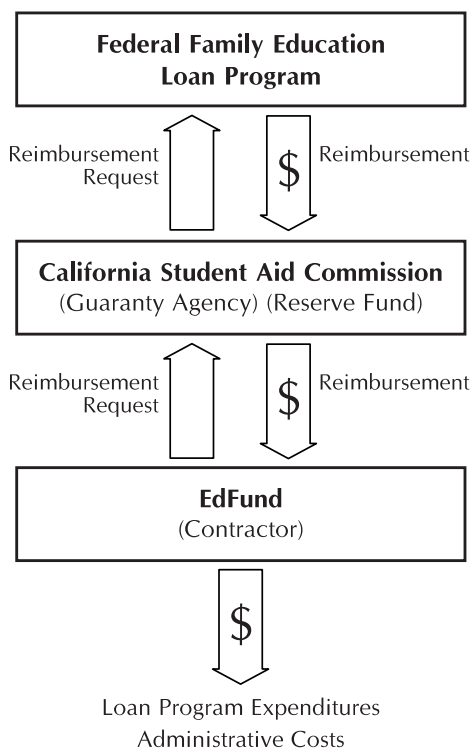
Loans are made available to students attending postsecondary institutions through private lenders, such as banks and credit unions. The CSAC guarantees the loan. If a borrower defaults on the loan, the lender files a claim with the CSAC, which pays the lender a portion of the outstanding balance. The FFELP in turn reimburses the CSAC.

The federal government requires the CSAC to maintain a reserve fund—the State Guaranteed Loan Reserve Fund (reserve fund)—for the sole use of the FFELP. All default claims, collection expenses, and other costs incurred by administering the FFELP are fully covered by the reserve fund. The reserve fund is derived from the FFELP, loan insurance premiums paid by students, collections and fees from defaulted borrowers, and interest on investments.

The CSAC signed an operating agreement with the EdFund in January 1997 that authorizes the CSAC to pay the EdFund for FFELP expenses, such as salaries, benefits, equipment, and supplies. The CSAC is responsible for verifying that the expenses are legitimate before it reimburses them using the reserve fund. The following figure shows the flow of federal funds from the FFELP to the CSAC, and to the EdFund.

The EdFund is governed by a board of directors. As of September 1997, the EdFund's board consisted of eight directors. Because the commission appoints the board members, it has substantial control over the EdFund's operations. According to EdFund bylaws, the CSAC executive we investigated is an ex officio voting member of the EdFund's board. Three other directors are also commission members. These three members appointed the CSAC executive to be an executive at the EdFund. At the time, just these three directors, plus the executive, were serving on the EdFund's board.

Figure
Flow of Federal Funds to the EdFund



Scope and Methodology

To investigate the allegations, we reviewed state laws and regulations in the California Education and Government Codes, and the California Code of Regulations, concerning dual compensation, incompatible activities, and relocation expenses. We also examined the CSAC's policies on incompatible activities and salary advances, and reviewed documents, such as accounting and personnel records, as well as the minutes from both commission and EdFund board meetings. Finally, we interviewed several employees at the CSAC, including the executive.

[BLANK PAGE INSERTED FOR REPRODUCTION PURPOSES ONLY]

Chapter 1



The California Student Aid Commission's System for Administering the Federal Family Education Loan Program Creates Both Legal and Ethical Problems

Chapter Summary

The California Student Aid Commission (CSAC) has adopted a system for administering the Federal Family Education Loan Program (FFELP) that creates a conflict of interest. Specifically, because it permits a CSAC executive to also work as an executive of the EdFund—a CSAC contractor providing support for the FFELP—he has a conflict of interest. Also, when one individual holds these two executive positions simultaneously, no separation of duties exists. Although the commission members believe they have removed responsibility for overseeing the EdFund from the executive's CSAC duties, they have not.

The Executive's Dual Employment Creates a Conflict of Interest

The CSAC is responsible for ensuring that the EdFund operates in accordance with laws, regulations, and the terms of the agreement between the two. Because of this responsibility for oversight, if an individual is an executive of both entities, he has a conflict of interest.



An executive cannot both manage the EdFund and provide independent oversight through the CSAC.


In addition, the CSAC and the EdFund are different from for-profit businesses. As a guaranty agency for the FFELP, the CSAC has a fiduciary responsibility to the state and federal government, and to the taxpayers to ensure that program funds are spent economically and in accordance with laws and regulations. California's annual receipt of over \$300 million in FFELP funds is predicated on the CSAC complying with program requirements. As a not-for-profit organization, the EdFund and its directors also have a fiduciary responsibility to spend its funds prudently.


The California Government Code, Section 19990, prohibits an employee from engaging in activities or employment that is clearly in conflict with his or her duties as a state employee.

This section specifically prohibits state employees and officers from receiving compensation from entities other than the State for performing state duties. Additionally, it bars state employees from private activities that later may be subject to audit or review by themselves or their state employers. Under this law, in 1992, the CSAC adopted an incompatible activity statement prohibiting employees from the following actions:

- Outside employment that provides a service or initiates legal action related to the CSAC.
- Outside employment for which the employee is retained because of his or her position with the CSAC.
- Service as an officer, employee, or member of the board of directors of an organization that attempts to transact business with the CSAC when the employee can influence, however remotely, such transactions.
- Use of CSAC employment in any way to aid another agency or business for purposes of obtaining future employment at that agency or business.



In spite of state law and CSAC policy, commission members approved the executive's dual employment.




In spite of state law and the CSAC policy mentioned above, commission members approved employment at the EdFund for the executive under investigation. We believe the commission members acted imprudently when they approved the individual's dual employment.

On May 9, 1997, we met with the chairperson of the commission regarding some concerns about the apparent conflicts of interest created by the executive's dual employment. Also on May 9, the EdFund's attorney requested a legal opinion from the Office of the Attorney General on this issue, stating that the commission had approved the potential outside employment of the executive in November 1996. However, the minutes of the commission meeting in November do not reflect this approval.


The EdFund counsel also stated that the individual's employment at the EdFund complies with the CSAC policy and Section 19990 of the California Government Code; however, he stated that it was his impression that the executive no longer had responsibility for the FFELP. The EdFund counsel further stated that the individual's dual employment would not create a

conflict of interest. On October 24, 1997, the EdFund counsel asked the Office of the Attorney General to suspend work on the opinion until after issuance of this report.

We disagree that this individual's dual employment is appropriate under Section 19990. Further, although the CSAC revised its policy and approved the executive's employment by the EdFund, this dual executive role is an incompatible activity because his duties include both the oversight of the EdFund and the services it provides to the CSAC. Accordingly, it is a conflict of interest for this individual to serve as an executive of both entities and a violation of Section 19990 of the California Government Code.



The California Education Code explicitly prohibits employees of the EdFund from being employed by the CSAC.



Moreover, changing its policy does not address another basic problem. Although Education Code Section 69522.5(a) permits employees of the CSAC to be assigned to work for the EdFund, such assignments are allowed only for civil service employees. The executive is an exempt employee, not a civil service employee. Moreover, even when civil service employees are assigned to work for the EdFund, they remain CSAC employees; they do not receive compensation from both the EdFund and the CSAC. In fact, Section 69522.5(b) of the Education Code explicitly prohibits employees of the EdFund from being employees of the CSAC. In the absence of a statute that specifically permits the dual employment of the executive by both entities, it is prohibited.


The Executive's Dual Employment Has Compromised Controls Over Federal Funds

In addition to violating government codes, the individual's dual employment also creates an internal control weakness due to a lack of separation of duties. Maintaining a strong system of internal controls is critical to the CSAC ensuring that the EdFund is an effective, efficient, and legal operation and that it is fulfilling its contractual obligations to the CSAC. However, separation of duties does not exist because this individual is responsible for supervising, approving, and reviewing the operations of both entities.

The Financial Integrity and State Manager's Accountability Act in the California Government Code, beginning at Section 13400, requires each state agency head to establish and maintain an adequate system of internal accounting and administrative controls designed to prevent errors, irregularities,

or fraudulent acts. Generally accepted principles of internal control prescribe that duties be separated so that no one person has complete control of more than one function, for example, both authorizing and certifying payments. One employee's work must routinely serve as a check on another's.

In addition, the independence of the two entities is compromised by the overlapping management. For example, according to its agreement with the CSAC, the EdFund must maintain adequate records and submit periodic reports to the CSAC showing its operational and financial status. The individual in question is responsible for preparing or approving the reports for the EdFund. As an executive of the CSAC, he is also responsible for reviewing, or supervising the review of, these same reports to ensure compliance.



Even if the CSAC executive does not review EdFund activities himself, he still has a conflict because of his supervisory position over CSAC employees who may actually perform that function.

The problems of lack of separation of duties and conflict of interest clearly exist. Even if the CSAC executive does not review EdFund activities himself, he still has a conflict because of his supervisory position over CSAC employees who may actually perform that function. The executive, as the head of both organizations, cannot delegate ultimate responsibility and authority; these reside with the two executive positions.



Although the Commission Believes It Has Removed Responsibility for Overseeing the EdFund From Its Executive, It Has Not

The commission contends that on January 2, 1997, it significantly narrowed the duties of its executive, eliminating all those relating to the conduct of the federal loan programs, including the FFELP. The January 1997 duty statement only lists state-operated CSAC programs. Presumably, because the federal loan programs were not listed, they no longer fall within the executive's responsibilities.

However, we found substantial evidence that the individual, in his position at the CSAC, continues to oversee the EdFund. In July 1997, according to its minutes, the commission's audit committee emphasized that both the executive and the internal auditor have responsibility for reporting all internal and external audits, both of the commission and of the EdFund, to the committee.



In addition, the CSAC Internal Audit Charter (charter), signed by the CSAC executive and by the commission chairperson in September 1997, specifies that the CSAC internal auditor

reports administratively to the executive. It also specifies that the internal audit scope includes review of EdFund operations for transactions affecting the reserve fund. As stated earlier, the federal government requires the CSAC to maintain this reserve fund for the sole use of the FFELP. The charter further stipulates that the executive is responsible for ensuring that appropriate CSAC management gives adequate consideration to the findings and recommendations provided in any audit report. Clearly, the commission has not narrowed its executive's duties to exclude oversight of the FFELP.

Separation of Duties Remains Unclear

On November 21, 1997, the commission chairperson wrote a letter to the executive and his administrator confirming the separation of duties between the executive and the administrator commencing on January 2, 1997. According to the chairperson, the administrator's duties were expanded to include oversight of the operating agreement between the CSAC and the EdFund. The chairperson also specified that the administrator would report directly to the commission; the executive would supervise no part of these specific duties.

However, overseeing and administering the EdFund is also an incompatible activity for the administrator. Specifically, the administrator acted as an interim vice president for the EdFund beginning January 2, 1997. Consequently, it would also be improper for her to review EdFund activities while she was vice president.²


Although the chairperson stated that the division of duties between the administrator and the executive has been in place since January 2, 1997, we found substantial evidence to the contrary.



In addition, according to the administrator's duty statement of September 5, 1997, she reported to the executive. The duty statement did not mention her reporting directly to the commission. Further, we found no record of this change in the administrator's duties in the minutes of the commission's meetings.

On June 12, 1997, the administrator told us that, as of July 1, 1997, she would have responsibility for all programs and functions funded by the State General Fund—not the FFELP. Clearly, her understanding of the facts was not the same as that portrayed by the commission's chairperson.


²According to personnel records, she continued as interim vice president through at least August 7, 1997.

The administrator also told us on June 12 that she was not aware that the CSAC had reimbursed the EdFund for relocation expenses and a bonus it had improperly paid to the executive. (We discuss these improper payments further in Chapter 2.) However, the CSAC submitted documents on April 29, 1997, asking the State Controller's Office to issue payment to the EdFund for these and other expenses totaling more than \$4.8 million from federal funds. If, in fact, the administrator is the CSAC employee responsible for ensuring that the EdFund spends federal funds properly, she should have been aware of this reimbursement.

Even by establishing a dual reporting structure for the administrator, the commission has not succeeded in fully removing the opportunity for the executive to exercise influence over her actions. As long as she or any other CSAC employee reports in any way to the executive, the executive is in a position to influence that employee. As an example of the influence the executive has over the administrator's career and financial status, in August 1997, the executive approved a reclassification of her position, resulting in a substantial salary increase. As the administrator's appointing authority, the executive can approve reclassifications of her position or changes in her salary.



Delegating certain duties does not change the fact that the ultimate responsibility of all of CSAC's activities resides with its executive director.



Finally, we find the commission's efforts to remove FFELP responsibilities from the CSAC executive inappropriate and superficial. The ultimate responsibility of all its activities, state and federal, rests with the CSAC executive and cannot be delegated. Therefore, we find the executive's dual role inappropriate and incongruent. The same individual cannot fill both roles if the CSAC is to fulfill its responsibilities over the FFELP.

Chapter 2

The California Student Aid Commission Does Not Ensure That Federal Funds Are Spent Appropriately

Chapter Summary

The California Student Aid Commission (CSAC) is not fulfilling its responsibility to ensure that public funds are expended appropriately. Specifically, because the commission permits dual employment of a CSAC executive at the EdFund, the taxpayers have paid \$91,000 more for this individual's services in 1997. This additional pay may also violate state law.

In addition, to avoid violating state law to pay the same individual \$39,861 in January and February 1997 for a bonus and relocation expenses, the CSAC used the EdFund to pay him. These payments were made through the EdFund even though they were for activities that occurred while the individual was a CSAC employee and prior to the existence of the EdFund. The CSAC then improperly reimbursed these payments from federal funds.

After we brought our concerns to the commission's attention, the EdFund board of directors requested the executive to repay the bonus and relocation reimbursement, which he did on June 30, 1997. On the same day as the repayment, the EdFund, at its board of directors' instruction, paid the individual an inappropriate \$40,000 bonus, using federal funds.

Further, because it has transferred many of its oversight resources, such as legal counsel, internal auditors, and administrative staff, to the EdFund, the CSAC cannot protect the public funds in its care.

The Executive's Dual Employment Costs the Taxpayers Substantially More

In addition to creating conflicts of interest, the executive's dual employment results in the taxpayers paying substantially more for the executive's salary than they did before the creation of

the EdFund. Specifically, in calendar year 1997, taxpayers paid this individual approximately \$199,693, over \$91,000 more than they would have paid if the EdFund had not been created.

By state law, the CSAC executive's salary cap is \$8,995 per month. During the first six months of 1997, the CSAC and the EdFund paid the individual a combined salary of \$15,839 per month. In addition, in June 1997, the EdFund paid him \$40,000 as a signing bonus.³ The following table shows the executive's compensation for 1997.

Table

The Executive's Compensation From the CSAC and the EdFund—Calendar Year 1997

Month	CSAC Payments	EdFund Payments	Total Payments
January	\$ 8,995.00	\$ 6,844.04	\$ 15,839.04
February	8,995.00	6,844.04	15,839.04
March	8,995.00	6,844.04	15,839.04
April	8,995.00	6,844.04	15,839.04
May	8,995.00	6,844.04	15,839.04
June	8,995.00	46,844.03*	55,839.03
July	899.50	9,877.00	10,776.50
August	899.50	9,877.00	10,776.50
September	899.50	9,877.00	10,776.50
October	899.50	9,877.00	10,776.50
November	899.50	9,877.00	10,776.50
December	899.50	9,877.00	10,776.50
Total Payments	\$59,367.00	\$140,326.21	\$199,693.21

*This amount includes the signing bonus of \$40,000.



Moreover, the individual's dual employment may violate another state law. Section 18000 of the California Government Code states that the salary fixed by law for each state officer is compensation in full for that office and for all services rendered in any official capacity during the term of office. This section prohibits a state officer from receiving any fee or perquisite for the performance of any official duty.

The EdFund's attorney argues that the executive's dual employment does not violate Section 18000. He cites an attorney general opinion from 1943 that concludes an official's employment by two separate entities is not

³ The \$40,000 signing bonus is discussed later in this report.

precluded by Section 18000 if the duties of each salaried position are distinct from one another.⁴ He further refers to the January 2, 1997, duty statement for the CSAC executive discussed earlier as evidence that the individual's duties for each position are distinct. Based on the CSAC's payroll records, the individual spends 10 percent of his time working for the CSAC on issues not related to the Federal Family Education Loan Program (FFELP) and 90 percent of his time working for the EdFund on the FFELP.⁵ Therefore, the commission believes payments from the EdFund do not constitute dual compensation.

However, although the EdFund was created to assist with participation in the FFELP, the CSAC is the State's designated guaranty agency and is ultimately responsible to the federal government for that program. In fact, legislation creating the EdFund specified that the CSAC maintains its responsibility for financial aid program administration, policy leadership, program evaluation, and information development and coordination.


The CSAC executive is responsible for oversight of the EdFund and is paid by the CSAC to sit on the EdFund board of directors; since the duties of the two positions are not distinct, he cannot be compensated by the EdFund.


Further, the EdFund's bylaws designate the CSAC executive an ex officio voting member of the EdFund's board of directors by virtue of his position with the CSAC. In addition, as we point out on page 8, its own meeting minutes document that the commission continues to expect the executive to oversee and review the FFELP and the EdFund. Since the CSAC executive is responsible for oversight of the EdFund and is paid by the CSAC to sit on the EdFund's board of directors, the duties of the two positions are not distinct. He cannot receive additional compensation from the EdFund in any form without violating Section 18000. Moreover, because the CSAC reimburses the EdFund for the executive's salary, the CSAC is paying compensation for the executive that it cannot, by law, pay him itself.

In a similar situation involving another state agency, the California Museum of Science and Industry (museum), the Office of the Attorney General, and the Department of Personnel Administration issued a joint legal opinion that Section 18000 of the California Government Code prohibited the museum's executive director from receiving any compensation above his state salary for performing his official


⁴ 2 Op. Cal. Atty. Gen. NS-5226.

⁵ Before the EdFund was created, approximately 85 percent of CSAC workload was related to this federal program. As the preceding table shows, the executive's salary from the CSAC and the EdFund changed in July 1997. Effective July 1997, each entity computed the executive's salary based on the proportion of time spent performing duties for the CSAC and for the EdFund. For example, the CSAC paid the executive \$899.50 based on his spending 10 percent of his time on duties unrelated to the FFELP. This amount represents 10 percent of his full salary of \$8,995.


duties.⁶ His official museum duties included serving as an executive officer of a nonprofit auxiliary foundation. The legal opinion stated that the director's compensation included his duties as executive officer of the organization. Given the prohibitions of Section 18000, the foundation could not pay separately for performing that function. To address the dual compensation issue for the director, the Legislature enacted Section 18000.5 of the California Government Code in 1986 to exempt the museum.

Although the museum director's situation is similar to the CSAC executive's, there is an important difference. Specifically, the museum's auxiliary foundation involves no federal funds while the EdFund does. Consequently, the museum does not have the same level of responsibility of oversight as the CSAC.

Commission Members Attempted To Use the EdFund To Circumvent State Laws



EdFund paid the executive relocation expenses and a salary bonus.




The members of the commission circumvented state laws by using the EdFund to pay relocation expenses of \$20,734 and a bonus compensation of \$19,127 to the executive. Under state law—and according to the Office of the Attorney General, the Department of Personnel Administration, and its own general counsel at the time—the CSAC could not legally pay either a bonus or relocation expenses. In addition, the CSAC's own legal counsel told certain commission members they could not set the executive's compensation level. Because it could not legally make the payments, the commission used the EdFund to make the improper payments to the employee.

State Law Precluded Payment of Relocation Expenses

According to its chairperson at the time, when the commission hired the individual in July 1995, it told him it would do everything legally possible to obtain reimbursement of his relocation expenses after he accepted the CSAC position. Relocation expenses are costs of selling a personal residence, including the brokerage fee for the sale of the residence and other closing costs. However, in December 1995, the Office of the Attorney General concluded that the CSAC could not reimburse the individual for these expenses. Section 19841 of the California Government Code restricts relocation expenses to

⁶The California Museum of Science and Industry is now known as the California Science Center.

instances when the State requires the move. Although the individual was an employee of the California State University (CSU) when he accepted the CSAC position, CSU employees are not considered state employees for relocation purposes and the CSAC had no legal authority to pay these expenses.


When CSAC found it had no legal authority to pay relocation expenses, it asked EdFund to honor its commitment.

Nevertheless, on January 23, 1997, the commission requested that the EdFund honor the commission's previous commitment to reimburse its executive's relocation expenses. On January 24, 1997, CSAC employees issued an EdFund check to the individual for \$20,734 in relocation expenses. Although Section 69526(a) of the California Education Code requires the EdFund's board of directors to approve all expenditures and fund authorizations, the board neither discussed nor voted on this payment. At that time, three of the four members of the EdFund's board of directors were also members of the commission, and the executive was the fourth member.

Further, because the relocation expenses covered the cost of selling the individual's home in 1995—more than 16 months before the creation of the EdFund—the expenses were unrelated to the EdFund's business.

The Bonus Paid by the EdFund Was for CSAC Performance

Also on January 23, 1997, the commission requested the EdFund to pay this individual a bonus for his exceptional performance as a CSAC executive. The bonus was 20 percent of his CSAC salary from July 5, 1995, through May 31, 1996. On February 27, 1997, CSAC employees issued another EdFund check for \$12,346, the net amount, after federal and state payroll deductions, from the \$19,127 bonus.

The bonus compensation payment to the CSAC executive was neither discussed nor separately voted upon by the EdFund's board of directors, as required by the California Education Code. The EdFund's chairperson at that time was also the chairperson of the commission. Two of the three other board members were commission members, and the executive was the third.

As with the relocation expenses, the bonus was unrelated to EdFund business. During the time period covered by the bonus, the EdFund did not exist. In addition, both the EdFund chairperson and the interim vice president, who approved the

payment, knew the bonus was improper.⁷ In a memorandum to the EdFund's controller dated February 27, 1997, the interim vice president wrote that the bonus should be treated as a one-time signing supplement to the individual's EdFund executive salary. The controller and the interim vice president described the payment as a signing supplement when they met with the executive. In fact, the interim vice president acknowledged that the payment was characterized as a signing supplement because the EdFund should not pay for services rendered before its existence.

The Executive Repaid the Improper Disbursements

—◆—
Soon after being asked to repay the EdFund, the executive paid \$33,080.
—◆—

On May 9, 1997, we questioned why the EdFund's board of directors had not voted on the payments and why the EdFund had paid for expenses unrelated to its business. Nineteen days later, on May 28, 1997, the EdFund's board of directors requested that the individual repay the bonus and the relocation reimbursement. According to the EdFund's board of directors' minutes for May 28, 1997, the board requested the repayment because it did not approve either payment. As of June 30, 1997, the individual had repaid the EdFund for the bonus and the relocation reimbursement.

The CSAC Did Not Ensure That Its Contractor Spent Federal Funds Appropriately

Despite their request for repayment, during the same meeting on May 28, 1997, the EdFund's board of directors authorized a \$40,000 bonus to the individual, which they paid from federal funds. The payment, made on June 30, 1997, was classified as a signing bonus. Although the minutes of the meeting were not specific, the EdFund's attorney stated that the bonus was paid in recognition of the executive's qualifications, his outstanding work in creating the EdFund, and his successful leadership during its first six months of operation. Again, according to the EdFund's attorney, this work involved duties above and beyond those of a state manager.

We believe, however, that this is an inappropriate expenditure of federal funds. First, the State had already paid the executive for his work in creating the EdFund. Second, the EdFund surely recognized the executive's qualifications when it hired him.

⁷The EdFund's interim vice president was also a CSAC administrator.



Third, the EdFund must have expected that the executive would successfully lead the organization when it hired him. Fourth, as shown in the earlier table, the EdFund had already increased the individual's salary from \$8,995 to \$15,839 per month. Presumably, the additional \$6,844 per month would compensate the executive for any extraordinary duties. Fifth, the payment was made as a result of the individual's dual employment which is, in itself, a violation of law.

The United States Department of Education issued regulations, effective July 1, 1997, that placed a cap on the total compensation from a reserve fund to individuals such as the executive. The EdFund's board knew about these regulations when it voted on the bonus: the meeting minutes indicate that it approved this bonus to raise his overall compensation before the regulations were to take effect. It appears the board provided the bonus to circumvent the intent, if not the letter, of the regulations.

***The CSAC Has Inappropriately Diverted
Its Legal and Administrative
Resources to the EdFund***

The CSAC has transferred many of its personnel to the EdFund. Consequently, it does not have adequate resources to protect public funds entrusted to it. For example, before the creation of the EdFund, the CSAC employed two attorneys and contracted with several others to provide advice and representation as needed. On October 25, 1996, the commission voted to transfer the two attorneys to the EdFund and terminated its contracts with outside counsel who provided the EdFund with legal services. Although the California Attorney General provides a deputy attorney general to assist the CSAC, on at least one occasion this deputy attorney general was unable to do so.

As a specific example of the lack of necessary resources, when we discussed various issues with the present and past chairpersons of the commission in November 1997, they brought two EdFund contract attorneys with them instead of a deputy attorney general or CSAC counsel. If the CSAC had a dispute with the EdFund, the CSAC would be at a severe disadvantage because it does not have adequate representation.


No one at the CSAC reviews and approves the expenditures that support invoices from the EdFund to ensure that they comply with federal regulations and laws because staff believe it would be very time consuming.


In addition, before the EdFund was created, the CSAC employed eight internal auditors. However, as of July 1, 1997, the CSAC employed only one. The other auditors either transferred to other state agencies or have been assigned to other CSAC/EdFund operations. As stated on page 9, the CSAC's internal auditor is responsible for reviewing EdFund operations for transactions affecting the reserve fund. Before the creation of the EdFund, the CSAC had eight internal auditors to review the CSAC's handling of the reserve fund. Even though this responsibility is the same, the CSAC has only one internal auditor to fulfill it.


Further, the CSAC is not ensuring that the invoices it receives from the EdFund are for appropriate expenditures before requesting reimbursement from the State Controller's Office. The fact that the CSAC is not checking invoices for appropriate expenditures occurs, at least in part, because the CSAC has transferred many of its administrative staff to the EdFund. According to the head of the CSAC's management services division, because it would be very time consuming, no one at the CSAC reviews and approves EdFund expenditures to ensure that they comply with federal regulations and laws. She said that a detailed review of EdFund expenditures would be performed only during a formal audit.

Good systems of control require that someone verify that services have been received and requests for reimbursement are for proper expenditures before contractor invoices are approved for payment. Once such a determination is made and an invoice approved, a department's accounting staff should prepare a claim schedule, which is then sent to the State Controller's Office for payment.


However, the CSAC is not exercising these controls. As a result, it is not fulfilling its responsibilities to the federal government or the taxpayers. For example, two EdFund invoices dated in early 1997 indicated that a CSAC accounting employee prepared the invoices requesting reimbursement for approximately \$9.7 million in expenses. This same employee approved the invoices for payment.

Another EdFund invoice dated June 30, 1997, indicated that this same employee prepared the invoice requesting the CSAC to reimburse EdFund expenses totaling \$6.9 million. She approved this invoice for payment on July 11, 1997, after she went to work for the EdFund. There are questions concerning whether the employee actually prepared the invoices. Nevertheless, the invoices received by the CSAC's accounting office indicated an absence of proper separation of duties and proper approval. In spite of these indications that the invoices

were not properly approved, the CSAC submitted them to the State Controller's Office for payment from federal funds.



Because of its lack of controls, the CSAC made a duplicate payment of \$1 million to the EdFund.



We did not perform a detailed review of the EdFund's invoices to determine whether all of their expenditures were appropriate. However, on October 30, 1997, a CSAC accounting employee submitted two other invoices, for July 1997 and August 1997, to the State Controller's Office, requesting a payment of approximately \$10 million from federal funds to the EdFund. Neither invoice contained evidence that it had been approved by a CSAC employee who verified expenses. Neither provided sufficient detail for any CSAC employee to make such a determination. In fact, the invoice for August requested reimbursement for an expense of approximately \$1 million that was also claimed on the July invoice. This duplicate billing was obvious from the most cursory review of the invoices. Despite what should have been an obvious discrepancy, the CSAC accounting office prepared a claim that resulted in the State Controller's Office using federal funds to pay \$1 million twice for the same expense.

When we asked about this duplicate billing, a member of the EdFund's accounting staff told us that the EdFund was aware of the erroneous billing and was taking action to correct it. Approximately two months after the duplicate payment was made and two weeks after we asked about it, the EdFund submitted a correction to the CSAC. Although the error was ultimately corrected, the CSAC did not fulfill its responsibility for ensuring that federal funds are only used for legitimate purposes.

Blank page inserted for reproduction purposes only.

Chapter 3

The California Student Aid Commission Paid an Improper Salary Advance

Chapter Summary

The California Student Aid Commission (CSAC) violated the State's policy on salary advances. In effect, the \$28,647 advance was a short-term loan to the executive in question to purchase a new home.

A CSAC Employee Made an Improper Salary Advance to a State Executive

—◆—
State rules allow salary advances to alleviate a serious, unforeseen circumstance and require a written detailed explanation from the employee.
—◆—

The CSAC paid an advance of \$28,647 to the CSAC executive on August 16, 1995, even though he was employed for less than two months. According to a CSAC employee who processed the advance, the CSAC expected the individual would receive his accrued vacation pay from the California State University (CSU), his previous employer. However, the CSAC employee did not have the authority to issue the advance. She first attempted to get CSU and the State Controller's Office to expedite a warrant for vacation pay; however, the two agencies refused. The CSU feared that an overpayment would occur while the State Controller's Office did not explain its refusal.

The State Administrative Manual, Section 8595, permits an agency to make a salary advance to an employee when the payment is necessary to alleviate a serious, unforeseeable hardship. According to the CSAC procedure, each employee must provide a detailed written explanation for the advance. Also, each employee must specify which resources were exhausted prior to submitting the request. The CSAC reviews salary advance requests on a case-by-case basis.

Unlike other CSAC employees, the individual did not supply a written explanation of an emergency or hardship. Nevertheless, because the executive's administrative assistant told the employee to do everything she could because the executive was purchasing a new home, the employee believed the only alternative was to give the executive a salary advance. The executive repaid the loan on August 31, 1995—17 days after receiving it.

The CSAC violated several requirements for a salary advance in this case. Although the State normally issues a salary advance for an amount approximating actual net monthly pay, the individual's advance was three times his monthly gross earnings. Additionally, the executive had not earned sufficient salary at the CSAC to justify such a large advance since he began working for the CSAC the previous month. An employee can only request a salary advance that is less than or equal to earnings based on the time already worked during the month.

Another requirement of a salary advance for a state employee is that it cover an emergency or a hardship. We do not believe that the individual's use of the salary advance as a down payment on a house represents a hardship or emergency. Also, the CSAC did not require the employee to report the other resources that he exhausted before he requested the advance. In effect, the CSAC made a short-term, no-interest loan of \$28,647 to the employee. Loans of public funds are prohibited by law.

According to the individual, the CSU failed to pay him for unused vacation time by the date it had specified, and the CSAC reneged on paying his relocation expenses. He added that, since he knew nothing about the state payment system, he asked a subordinate CSAC employee to review the payment problem. According to the executive, the subordinate told him the CSAC could issue a check for the accrued vacation pay. Nevertheless, while the CSAC can issue such payment for unused vacation to terminating CSAC employees for which it maintains payroll records, it has no authority to issue payment for unused vacation earned at the CSU and for which it has no supporting payroll records. The executive further stated that he was not asked to submit any paperwork and assumed he did not need to. Later, when he received his accrued vacation pay from the State Controller's Office, he immediately endorsed the checks over to the CSAC to repay the advance.

Conclusion

The California Student Aid Commission (CSAC) engaged in improper governmental activities. Specifically, it does not ensure that federal funds under its control are protected and spent appropriately. Because it permits a CSAC executive to perform the duties of an EdFund executive, an inherent conflict of interest exists between the two positions. The executive has incompatible responsibilities to both operate the Federal Family Education Loan Program and provide oversight for this program.

Further, before the EdFund was created, this individual performed all of the same duties for the salary he was paid by the CSAC. However, now that he works for both the CSAC and the EdFund, the taxpayers pay substantially more for his services.

In addition, the CSAC attempted to use the EdFund to illegally pay the individual a bonus of \$19,127 and a relocation reimbursement of \$20,734. Although the individual repaid these moneys following our investigation, these payments were an improper use of federal funds. In addition, the CSAC improperly condoned the use of federal funds to pay the executive a \$40,000 bonus.

Moreover, the CSAC has transferred many of its legal and administrative personnel to the EdFund. As a result, it is not ensuring that the federal funds entrusted to it are spent appropriately. For example, the CSAC approved a duplicate payment of \$1 million to the EdFund.

Finally, the CSAC issued an improper loan of \$28,647 to the individual.

We conducted this investigation under the authority vested in the California State Auditor by Section 8547 of the California Government Code and in compliance with applicable investigative and auditing standards. We limited our review to those areas specified in the scope of the report.

Respectfully submitted,

A handwritten signature in black ink, reading "Kurt R. Sjoberg". The signature is written in a cursive style with a prominent initial "K".

KURT R. SJOBERG
State Auditor

Date: March 31, 1998

Investigative Staff: Ann K. Campbell, Director, CFE
Dore C. Tanner, CPA, CFE

Audit Staff: Debra L. Maus

Agency Response

Because the governor appoints most of the members of the commission, we submitted our report to the Governor's Office for response. The Governor's Office strongly disagrees with our conclusions regarding the legality of the executive's dual employment and compensation paid by the EdFund. For example, the Governor's Office believes that the statutory framework that established the EdFund envisioned a highly integrated operation between the California Student Aid Commission (CSAC) and the EdFund. Consequently, the Governor's Office does not believe that the individual's employment by both entities is incompatible or that it creates conflicts of interest.

Further, the Governor's Office does not agree with our conclusion that the individual's dual employment violates the section of the Education Code cited in our report. Furthermore, the CSAC obtained an opinion from a private law firm that similarly concluded the individual's dual employment does not violate the law.

Although the Governor's Office believes the executive's dual employment is legal and does not compromise controls over the use of federal funds, it has recommended that the commission end the executive's employment with the CSAC and that he devote all of his energies to the EdFund. The CSAC's commission accepted the executive's resignation from his position at the CSAC, effective March 16, 1998.

To further address our concerns over controls, the Governor's Office has recommended that the commission's audit committee be assigned responsibility for oversight of all future interactions with the EdFund. On March 16, 1998, the commission announced the creation of a three-person ad hoc committee on EdFund oversight.

Although the Governor's Office agrees that the CSAC's advance of approximately \$28,000 to the executive was not made in accordance with the State's policies on advances, the Governor's Office believes it was extended in good faith. Finally, the Governor's Office believes that the EdFund had full discretion to pay its executive a \$40,000 bonus.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps