

Department of Resources Recycling and Recovery

Deficiencies in Forecasting and Ineffective Management Have Hindered the Beverage Container Recycling Program

REPORT NUMBER 2010-101, JUNE 2010

Department of Resources Recycling and Recovery's response as of December 2010

The Joint Legislative Audit Committee (audit committee) asked the Bureau of State Audits (bureau) to review the Department of Resources Recycling and Recovery's (department) management of the Beverage Container Recycling Program (beverage program) and the financial condition of the Beverage Container Recycling Fund (beverage fund). The audit committee wanted us to determine how the department forecasts revenues and expenses as well as the methodology it used to calculate the reductions in payments and fee offsets. In addition, the audit committee requested that we evaluate the department's procedures for ensuring that all fees are collected from beverage distributors and how it investigates potential fraud. Further, we were asked to review a sample of grant award expenditures for the past five years and determine how the department monitored these funds. Finally, the audit committee requested that we evaluate the department's ability to assess the efficiency and effectiveness of the beverage program.

Finding #1: Deficiencies exist in forecasting revenues and expenditures of the beverage fund.

Because of deficiencies in its forecasting process, the department is not always able to reliably project the revenues and expenditures for the beverage fund. We noted that over the past five fiscal years, its forecasting model has produced results that differ by between 3 percent and 15 percent from the actual revenues and expenditures. Ineffective supervisory oversight and lack of review of the accuracy of the forecasts have also weakened the value of the forecasting model. For example, the department failed to detect errors in its forecasting of the beverage fund condition, which resulted in a \$158.1 million overstatement of the fund balance in the 2009–10 Governor's Budget. Moreover, the department incorrectly calculated a reduction in payments to recyclers and others due to an error in computing its reserve for the projected fund balance in its May 2009 forecast. Further, the Department of Conservation did not include prior-year adjustments and incorrectly presented the actual fund balances of the beverage fund for three fiscal years—2004–05 to 2006–07.¹

We recommended that the department implement a new forecasting model in time for it to be used for the fiscal year 2011–12 Governor's Budget. We also recommended that appropriate controls be put in place to monitor the reliability of the model and that the department

¹ Until January 1, 2010, the Department of Conservation administered the Beverage Container Recycling Program.

Audit Highlights . . .

Our audit of the Beverage Container Recycling Program (beverage program) at the Department of Resources Recycling and Recovery (department) revealed the following about the department:

- » *Its forecasting process is outdated and not able to reliably project revenues and expenditures.*
- *Over the past five years, projections have differed from actuals by between 3 percent and 15 percent.*
- *Errors in forecasting the condition of the Beverage Container Recycling Fund resulted in a \$158.1 million overstatement in the 2009–10 Governor's Budget.*
- *A projected fund balance deficit in May 2009 prompted the department to reduce payments to beverage program participants.*
- » *Significant lags exist between the completion of an audit of redemption payments and billing for any identified underpayments.*
- *For one audit with identified underpayments of \$941,000, including interest, the department took six months to bill the distributor.*
- *In two instances, the department could not collect a total of \$324,000 because it exceeded the two-year statute of limitations on collecting underpayments.*

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- » *It may be missing opportunities to detect fraud because it lacks a systematic and documented methodology for analyzing data regarding the volume of recycled containers.*
- » *It does not always perform key steps to monitor grants awarded to private entities and local governments and ensure that funds are properly used by visiting grantees and obtaining project status reports.*
- » *It did not ensure grantees met their commitments for six completed market development and expansion grants that we reviewed—ultimately costing the State nearly \$2.2 million.*

continue with its effort to hire an economist to lead its forecasting efforts. In addition, we recommended that the department ensure that the contingency reserve for the beverage fund not exceed the statutory limit specified in the Public Resources Code. Finally, we recommended that the department ensure that the actual fund balance of the beverage fund reflect actual revenues and expenditures from its accounting records in future governor's budgets.

Department's Action: Partial corrective action taken.

The department redesigned its forecasting methodology, which it used for the October 2010 fund projection. In addition, the department implemented review procedures, including a process to compare actual sales and return values with prior projections. Further, the department stated that it will follow the Public Resources Code when calculating the contingency reserve and will propose a change in the fund reserve statute to ensure the recycling fund's ability to pay consumer deposits when they recycle. The department also developed a procedure to reconcile its records with the State Controller's Office data to ensure correct information is presented to the Department of Finance for preparing the governor's budget. Finally, following the August 2010 hiring freeze, the department indicated that it had to suspend its process for hiring an economist to assist in revising the forecasting model.

Finding #2: The department audits beverage distributors inconsistently and could do more to pursue underpayments.

The department is required to establish an auditing system to ensure that redemption payments that are made to the beverage fund comply with state law. However, the department has not followed its three-year plan to audit the top 100 beverage distributors, who provide 90 percent of revenues for the beverage fund, and a sample of mid-sized distributors and others that pose a risk to the beverage fund. Moreover, when audits were conducted, a significant lag existed between the audit's completion and billing for identified underpayments, which increased its risk for failing to collect underpayments before the two-year statute of limitations expired. In fact, for one audit with identified underpayments of \$941,000, including interest, the department took six months to bill the distributor. Further, we identified two instances in which the department exceeded the two-year statute of limitations and lost the opportunity to collect a total of \$324,000, and a third instance in which it did not complete an audit, losing the opportunity to collect \$431,000. We also identified that the department is actively pursuing regulatory changes to require beverage distributors to register with it, and it is also pursuing regulatory changes to require registered distributors to notify the department if another entity has agreed to make payments on behalf of that beverage distributor.

We recommended that the department take steps to better follow its three-year plan to audit beverage distributors by considering the inclusion of a risk assessment process and policies to identify and terminate low risk audits. In addition, we recommended that the department strive to complete the fieldwork for audits in a more timely fashion and to bill for collections sooner to avoid exceeding the statute

of limitations for collecting underpayments. Further, the department should take steps to implement policies to shorten the time needed to review completed audits before billings are made, and should also develop policies to expedite reviews when an audit identifies a significant underpayment. We also recommended that the department continue with its efforts to implement regulation changes that will require beverage distributors to register with the department and notify the department if another entity has agreed to make payments on behalf of that beverage distributor.

Department's Action: Partial corrective action taken.

The department has included a risk-based evaluation in its audit program to determine whether there is material harm to the fund and to terminate audits based on initial assessments. The department updated its current three-year audit plan to reflect this change, and its auditors received training on this risk-based process. Also, the department indicated that its Division of Recycling Integrated Information System (DORIIS) will include functions to track audit activity while also paying specific attention to the statute of limitations for each audit. In addition, the department indicated that it is working to develop criteria to rank findings and prioritize the review and completion of audits. The department did provide statute of limitations training for audit staff in its investigations and audits units in December 2010. Finally, the department stated that it is pursuing regulatory changes to regulate reporting of agreements where an entity has agreed to make payments on behalf of that beverage distributor.

Finding #3: Weaknesses exist in the department's investigation of potential recycling fraud.

The department conducts investigations of recyclers that collect used beverage containers from consumers to ensure that they do not commit fraud when claiming reimbursements from the beverage fund. Although the department tracks the status of the investigations that have been initiated or completed, it does not track all fraud leads received, nor does it record how it determined that no follow-up was needed on fraud leads that were not investigated. Further, because the department does not have a systematic and documented methodology for analyzing beverage program data regarding the volume of recycled containers, it is potentially missing opportunities to detect fraud. We also noted that in response to concerns over unusually high recycling rates, particularly for plastics, in October 2009 the department began an enhanced effort to detect and prevent fraud before it occurs. This effort, called the fraud prevention project, is intended to significantly increase the presence of department staff at recycling and processing centers. However, as of May 2010 the department had not yet fully evaluated the effectiveness of the fraud prevention project.

To improve management of its fraud investigations, we recommended that the department track all fraud leads that the investigation unit receives and the disposition of those leads. We also recommended that the department formalize the approach used to analyze recycling data for potential fraud and to develop criteria to use when deciding whether to refer anomalies for investigation. Finally, we recommended that the department continue to evaluate the effectiveness of the fraud prevention project to determine whether it is a cost-beneficial activity.

Department's Action: Partial corrective action taken.

The department drafted procedures for analyzing fraud tips and now uses DORIIS to track, assign, and follow up on fraud tips. Further, the department implemented the fraud detection modules in DORIIS that will use data collected from beverage manufacturers, beverage distributors, recyclers, and processors to analyze indicators of potential fraud. The department acknowledged that systematic and defined documentation of its current practices and methodology for reviewing recycling data for potential fraud would be valuable, but it has not yet developed and documented these procedures. The department indicated that it has developed a methodology to evaluate the effectiveness of the fraud prevention project, but it is awaiting completion of a data library in DORIIS before it can determine whether it is a cost-beneficial activity.

Finding #4: The department's grant management is generally effective, except for conducting certain monitoring activities.

To encourage and support recycling activities, state law authorizes the department to award grants to private entities and local governments, which totaled approximately \$67.5 million in fiscal year 2008–09. Although it has a process to monitor grantees to ensure that funds are used properly, the department does not always perform key steps, such as visiting grantees and obtaining status reports on how projects are progressing. When funding market development and expansion (market development) grants, which are intended to encourage new and innovative recycling techniques, the department accepts a level of risk that financial institutions would not accept. However, for six completed market development grants we reviewed, the department did not ensure that grantees met their commitments, which ultimately cost the State nearly \$2.2 million. For two of the grants, the department's failure to promptly process grant extensions contributed to the problems.

To allow the department to more effectively monitor the grant funds it awards, we recommended that the department conduct site visits and require regular status reports from grantees. We also recommended that the department require that cities and counties report how they spend grant funds. Further, we recommended that the department more closely scrutinize the risks associated with market development grants and maintain contact with recipients that are unable to meet the goals of their grants to determine if the goals may ultimately be achieved. Finally, we recommended that the department approve grant extensions in a timely manner.

Department's Action: Pending.

The department indicated that it has drafted changes to how it will conduct and document site visits of grantees. In addition, the department indicated that it will ensure regular status reports are submitted by grantees on time, which will include withholding payments when status reports are not current. The department further indicated that it is working to implement a reporting requirement for cities and counties. The department also indicated it is developing a process to do a risk analysis of each new market development grant. The department stated that it has already begun to review past market development grants to determine factors contributing to their success and sustainability, and that the evaluation will be expanded to contact with grantees. Finally, the department implemented a review schedule to determine, at least three months prior to the end of a grant agreement, whether an extension is required.

Finding #5: The department is taking steps to assess the efficiency and effectiveness of the beverage program.

Although the department's strategic plan for the beverage program includes high-level goals and outcomes, it does not have specific criteria that would allow it to measure the effectiveness of the beverage program.

To better measure its progress in meeting the goals of the beverage program, we recommended that the department weave benchmarks, coupled with metrics to measure the quality of its activities, into its strategic plan. Further, we recommended that the department include all relevant activities of the beverage program in the strategic plan.

Department's Action: Pending.

The department stated that as it refines its strategic plan, relevant beverage program activities such as metrics to achieve audit plans, inspections, and enforcement objectives as well as other program activities will be incorporated along with the means to measure the quality of the outcomes.