

Senate Bill 784: State General Obligation Bond Oversight

This bill, sponsored by the State Controller and State Treasurer, is intended to ensure maximum accountability and transparency regarding the expenditure of bond funds. On November 7, 2006, California voters approved five bond measures that authorized the issuance of bonds totaling \$42.6 billion for various public improvement projects. Given the unprecedented magnitude of bond expenditures by the State, it is critical that the public have access to information concerning the bond process and the status of projects in their communities.

Specifically, SB 784 requires:

1. Departments receiving proceeds from state general obligation bonds authorized on or after November 7, 2006 to file the following reports on the use of those funds: (a) an initial report detailing contacts, timeliness, likely uses and project locations, (b) quarterly progress reports, and (c) a completion report. The reports must be filed with state control agencies, including the Treasurer's office.
2. The Department of Finance, State Controller's Office (SCO) and the State Treasurer's Office to collaborate on establishing a website to post the information from the reports filed.
3. SCO to conduct financial and performance audits of bond expenditures. The SCO is to annually prepare an audit plan and may seek additional funding if there is a need for additional auditors. The bill will allocate up to 10 positions to the SCO.
4. The Treasurer to expand the contents of the debt report to include information on the amount of bond proceeds appropriated in the annual Budget Act, and the balance in the bond funds.

Background

On January 24, 2007, the Governor issued Executive Order S-02-07, prescribing accountability standards for bond expenditures. The executive order requires state departments that administer bond funds to prepare a plan that includes measures to provide front-end, in-progress, and follow-up accountability over bond expenditures. As a part of the follow-up accountability component, the state departments are to develop a plan to audit completed projects to determine whether expenditures were in line with goals laid out in the project strategic plan.

The SCO auditors would complement the Governor's Executive Order and provide essential *independent* oversight of bond expenditures. Under state law the SCO has the sole responsibility in determining and reviewing the legality and accuracy of state expenditures. The SCO auditing division also assures the accuracy of local government claims and financial statements submitted to the state and federal government by annually reviewing and revising audit guidelines, reviewing audits performed by independent local auditors under these guidelines, and performing field audits of a variety of state and federal programs. It is through the field audit activity that this unit annually identifies more than \$100 million of improper expenditures of state and federal funds.

Fiscal Impact

The estimated cost of 10 new auditor positions is approximately \$1 million, which would be drawn from the administrative share of the bond proceeds—a relatively insignificant cost in comparison with the \$42.6 billion in bond expenditures to be disbursed. Based on past audit exception rates, cost savings identified through the audits should far more than offset the expense. Over the last four fiscal years, the SCO's ratios of audit exception to audit costs were 17:1, 12:1, and 10:1, and 13:1, with an average exception rate of 13:1. Given the enormous scope of funding overseen by the 10 auditors, savings are expected yield an even higher average exception rate.

Support

SB 784 is supported by the California Taxpayer's Association and the California Teacher's Association.

Senate Bill 784 (Torlakson)

As amended on June 4, 2007

Fiscal Questions and Answers

1. *The bill stipulates that the auditing functions will be absorbed in the administrative costs of the project being audited and that the savings generated by improvements to project implementation will offset these costs. Are those savings attainable?*

Based on past experience, the Controller's Office has no doubt that the audit savings will more than offset the audit costs. We would be willing to discontinue this audit program if we can not demonstrate that savings more than offset costs. Over the last four fiscal years, the SCO's ratios of audit exception to audit costs were 17:1, 12:1, and 10:1, and 13:1, with an average exception rate of 13:1.

In addition, by publicizing findings and recommendations, these audits will result in process changes that will yield additional (if difficult to quantify) savings.

With only 10 authorized auditors (per the bill) and having audit responsibility over an unprecedented \$42.6 billion in bond expenditures, SCO staff must employ a risk-based approach and select only the programs or contractors that pose the highest potential for audit exception.

2. *Will the increased costs to support this level of additional reporting and the development of electronic systems (databases, website, etc.) result in fewer bond funded projects?*

Similar to the administrative support need associated with this bill, no funding for either reporting or electronic systems is requested or described in the bill. Resources needed would come from existing resources, with no impact on bond funded projects.

We note that the Governor's Executive Order S-02-07 includes in their accountability structure pre-expenditure reporting requirements, semi-annual reporting, and a DOF-run web site that may already include some of the same information.

3. *How does this bill broaden the SCO's audit powers to equal that of the State Auditor over bond projects?*

The SCO already has broad statutory authority to audit all documents relating to any disbursement from the State Treasury. The use of bond proceeds represents State disbursements that are within the SCO's audit jurisdiction, as demonstrated below in the Government Code authorities:

(Emphasis added):

*12410. The Controller shall superintend the fiscal concerns of the state. **The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provisions of law for payment.** Whenever, in his opinion, the audit provided for by Chapter 4 (commencing with Section 925), Part 3, Division 3.6 of Title 1 of this code is not adequate, the Controller may make such field or other audit of any claim or disbursement of state money as may be appropriate to such determination.*

12411. The Controller shall suggest plans for the improvement and management of the public revenues.

SB 784 provides a funding mechanism for the SCO to carry out its audit responsibility and to provide proper fiscal accountability over \$42.6 billion in bond funds.

4. *Wouldn't this bill reduce the amount of funds available for projects supported by the GO bonds?*

The audits will increase funds available for projects by identifying waste and inefficiency and by recommending system or process improvements. It should be noted that the proposed audit costs under this bill are significantly lower than those of the DOF auditors. For example, in DOF's audit of Proposition 40 bond funds administered by the Department of Parks and Recreation, DOF auditors spent \$11.2 million to audit \$1.19 billion in bond expenditures (approximately 1%). In comparison, with the SCO's current proposal to add 10 auditor positions, the costs would equate to less than .025% of the \$42.6 billion in bond expenditures to be audited. Proportionally, the cost for DOF's audit of Proposition 40 funds was 40 times higher than the SCO's current proposal of 10 auditor positions under SB 784.

Additionally, with regards to Prop 84, a five percent administrative share (the source of funding for these audits) is specified in that bond act (PRC 75070.5)

5. *How does the SCO's auditing proposal conform or conflict with the Governor's Executive Order S-02-07?*

The Governor's Executive Order explicitly supports the type of audits and reporting described in this bill. However, rather than using "follow-up accountability" to identify waste and inefficiency, SB 784 will improve project delivery and accountability for projects in progress. The bill will:

- Provide greater independence and public validity by having the SCO, rather than departmental internal auditors or audit firms hired by the departments, perform the audits.

- Provide a more systematic and consistent approach in audit selection and in application of audit procedures. For example, in an audit of the California Conservation Corps' (CCC) administration of Proposition 40 funds (released on June 21, 2007), the SCO found significant internal control deficiencies and oversight lapses that could have easily resulted in the misuse of bond funds. Moreover, despite a provision in the bond initiative specifically requiring the Secretary of the Resource Agency to "provide for an annual audit of expenditures from this chapter," we found that neither the Resource Agency nor the CCC made any arrangement or plan for such an audit during the five years of program implementation.
 - Provide for interim audits to make system or process improvements while the projects are in progress, in order to enhance audit effectiveness. The Governor's Executive Order calls for audits after projects are completed; by then, it may be too late to rectify some problems. We will incorporate into our audit plan interim audits, so that some issues can be addressed in a timely manner.
6. *Please explain what expertise the SCO has in terms of auditing these projects and how they will result in a more efficiently run project.*

Consistent with the State Controller's statutory responsibility of ensuring the legality and propriety of State disbursements, the SCO's primary audit focus is audit of State expenditures. Examples of program expenditures being audited by the SCO include Medi-Cal Program expenditures, mandated cost reimbursement claims, and expenditures incurred by the local governments under gas tax funds and road funds. Audits of bond expenditures are no different from any other SCO expenditure audits except that we will be auditing based on different criteria.

The SCO does have experience in auditing bond expenditures. Examples include:

- Auditing Los Angeles Unified School District's \$2.4 billion in Proposition BB Bonds. SCO auditors reported that the bond projects incurred a \$1.8 billion deficit because of poor fiscal oversight and excessive administrative expenses.
- San Jose Unified School District Measure C Bonds. SCO auditors found that expenditures were not processed in accordance with the district's policy and that some bond expenditures to be inconsistent with the intent of the voters.
- California Pollution Control Financing Authority's Dairy Farm Solid Waste Disposal Pollution Control Projects. SCO auditors found that trustee banks could not document that project funds were used for expenses necessary for the pollution-control projects, which could jeopardize the tax-exempt status of private activity bonds.

- The California Conservation Corps (June 2007) administration of Proposition 40 funds. SCO auditors found significant control deficiencies and oversight lapses that could easily result in misspent funds without the CCC's knowledge.

7. *What will be the SCO's administrative costs borne by departments or agencies using the specified GO bond funds?*

There is no mention of, or request for, administrative support in the bill. The 10 auditors will be supported by existing staff.