DEPARTMENT OF FINANCE
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May 26, 2010

Ms. Lucia C. Becerra, Acting Director
Department of Boating and Waterways
2000 Evergreen Street, Suite 100
Sacramento, CA 95815

Dear Ms. Becerra:

Final Report—Loan Compilation and Loan Process Review

The Department of Finance, Office of State Audits and Evaluations (Finance), has completed its loan portfolio compilation and assessment of the Department of Boating and Waterways' (Department) Small Craft Harbor and Recreational Marina Loan Programs.

The enclosed report is for your information and use. The Department's response to the report recommendations is incorporated into this final report. The Department agreed with our observations and we appreciate its willingness to implement corrective actions. The observations in our report are intended to assist management in improving its operations.

In accordance with Finance's policy of increased transparency, this report will be placed on our website. Additionally, pursuant to Executive Order S-20-09, please post this report in its entirety to the Reporting Government Transparency website at http://www.reportingtransparency.ca.gov/ within five working days of this transmittal.

We appreciate the assistance and cooperation of the Department. If you have any questions regarding this report, please contact Kim Tarvin, Manager, or Jennifer Arbis, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by:

David Botelho, CPA
Chief, Office of State Audits and Evaluations

Enclosure

cc: Ms. Debra DeVerter, Chief, Administrative Services Division, Department of Boating and Waterways
Mr. Steve Watanabe, Chief, Boating Facilities Division, Department of Boating and Waterways
Ms. Sylvia Hunter, Manager, Boating Facilities Division, Department and Boating and Waterways
Mr. Patrick Kemp, Assistant Secretary, Administration and Finance, California Natural Resources Agency

A Special Review

Department of Boating and Waterways
Small Craft Harbor and Recreational Marina Loan Programs
Loan Compilation and Loan Process Review

Source: Sacramento Marina, sample project illustration courtesy of the Department of Boating and Waterways

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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March 2010

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Final reports are available on our website at http://www.dof.ca.gov

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EXECUTIVE SUMMARY

The Department of Boating and Waterways (Department) requested the Department of Finance, Office of State Audits and Evaluations (Finance), to compile the Harbors and Watercraft Revolving Fund loan portfolio and review the approval and monitoring processes of the Small Craft Harbor and Recreational Marina Loan Programs.

RESULTS

Loan Portfolio

Finance compiled and provided the Department with a loan portfolio listing all active loans, loan terms, loan balances as of August 1, 2008, and other relevant information. Additionally, Finance provided information and templates to assist the Department in maintaining and updating the loan portfolio. See Table 1 for a summary of the Small Craft Harbor and Recreational Marina Loan Portfolio.

Table 1: Loan Portfolio Summary

Number of Loans		Authorized Loan Contracts	Funds Disbursed	Total Outstanding Loan Balances
Small Craft Harbor	Recreational Marina			
133	37	$351,500,000	$258,900,000	$219,400,000

Loan Approval and Monitoring Processes

The Department has processes to approve and monitor Small Craft Harbor and Recreational Marina loans. The following recommendations would strengthen program controls. The Department should:

- Develop detailed written policies and procedures.
- Improve interdepartmental communication.
- Improve loan file maintenance.
- Strengthen safeguarding of assets.
- Implement an integrated loan tracking system.

BACKGROUND, SCOPE, AND METHODOLOGY

BACKGROUND

Source: Stockton Waterfront, sample project illustration courtesy of the Department of Boating and Waterways

The California Department of Boating and Waterways (Department) develops convenient public access to California's waterways and promotes on-the-water safety. The Small Craft Harbor and Recreational Marina Loan Programs lend money to public and privately owned marinas for development, expansion, and improvement of boating facilities through the Harbors and Watercraft Revolving Fund (Fund). Specifically, loans to cities, counties, and other government agencies are for planning, construction, rehabilitation, or expansion of small craft harbors. Loans to private recreational marina owners are for development, expansion, and improvement of boating facilities accessible to the public.

SCOPE

At the Department's request, the Department of Finance, Office of State Audits and Evaluations (Finance), performed the following:

- Compiled the Fund's loan portfolio as of August 1, 2008.
- Identified recommendations to improve the loan approval and monitoring processes.

This review did not include a review of the efficiency or effectiveness of program operations.

METHODOLOGY

Loan Portfolio Compilation

To compile the Fund's Loan Portfolio as of August 1, 2008, we relied on the July 1, 2004 loan balances, interviewed current and former staff, sent confirmation letters, and reviewed the following documents:

- Historical loan reports and spreadsheets
- Final Budget Summaries
- Contract files

- Accounting files
- Invoices
- Loan amortization schedules
- California State Accounting and Reporting System (Calstars) reports and transactions
- Payment logs
- Checks

The loan portfolio included pertinent loan information such as the project name, loan recipient, contract/accounting file number, loan amount, loan term, interest rate, loan balance, etc.

Loan Approval and Monitoring Processes

To identify opportunities for improving the loan approval and monitoring processes, we performed the following:

- Gained an understanding of the loan processes and internal control structure.
- Reviewed applicable Harbors and Navigation Codes, program guidelines, and policies and procedures.
- Interviewed executive management, current staff, and former staff directly responsible for administering the Harbors and Watercraft Revolving Fund.
- Interviewed staff at another state department to identify best practices.
- Reviewed 73 accounting files and 7 program files for the following:
    - Whether program and accounting staff followed loan procedures
    - Adequacy of file maintenance
    - Proper authorization to support changes to the loan rate and loan term
- Identified areas of significant risk and recommendations to mitigate these risks.

The compilation results and recommendations included in the Results section of this report were developed based on the evaluation of data obtained, practices observed, and discussions with current and former staff. The review was conducted during the period March 2009 through February 2010.

Except as discussed below, the review was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our observations and recommendations based on our review objectives. We believe the evidence obtained provides a reasonable basis for our observations and recommendations.

In connection with this review, there are certain disclosures required by *Government Auditing Standards*. Finance is not independent of the Department, as both are part of the State of California's Executive Branch. As required by various statutes within the California Government Code, Finance performs certain management and accounting functions. These activities impair independence. However, sufficient safeguards exist for readers of this report to rely on the information contained herein.

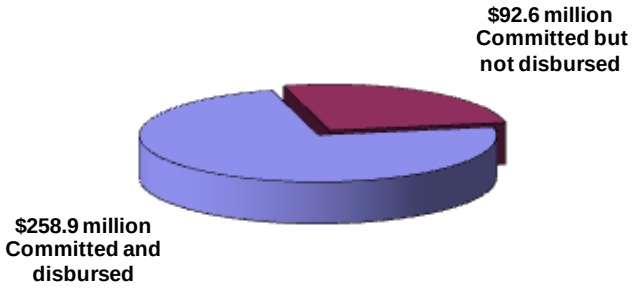
RESULTS

As requested by the Department of Boating and Waterways (Department), the Department of Finance, Office of State Audits and Evaluations (Finance), compiled the loan portfolio and reviewed the loan approval and monitoring processes for the Small Craft Harbor and Recreational Marina Loan Programs. Currently, the Department has loans in the approval, project completion, and loan repayment phases and some loan recipients have multiple loans.

LOAN PORTFOLIO COMPILATION

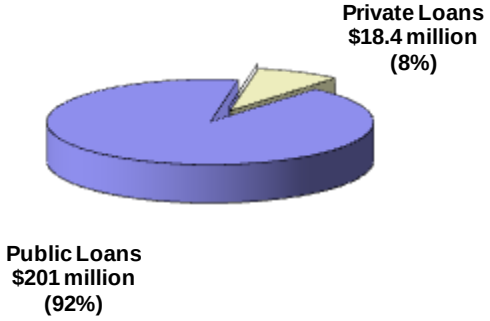
As of August 1, 2008, the Department had 170 active loans comprised of 133 Small Craft Harbor loans (78 percent) to public entities and 37 Recreational Marina loans (22 percent) to private entities. Of the $351.5 million in loans authorized and committed to specific projects, $258.9 million was disbursed. See Figure 1 for the composition of total loans authorized. The Department's total loan balance was $219.4 million. Of this amount, $201 million (92 percent) was due from public entities and $18.4 million (8 percent) was due from private entities. See Figure 2 for the outstanding loan balances. The terms of the loans range between 14 and 50 years with both fixed and variable interest rates.

Figure 1
Composition of Loans Authorized as of August 1, 2008



Finance provided the department with a loan portfolio listing all active loans, loan terms, loan balances as of August 1, 2008, and other pertinent information. Additionally, Finance provided the detailed calculations for each loan balance. Furthermore, Finance provided information and templates to assist the Department in maintaining and updating the loan portfolio. Due to the confidential nature of the information, the loan portfolio was not included in this report.

Figure 2
Outstanding Loan Balances as of August 1, 2008



LOAN APPROVAL AND MONITORING PROCESSES

The Department has processes to approve and monitor the Small Craft Harbor and Recreational Marina loans. However, there are opportunities for improvement. The proposed recommendations, if implemented, will minimize risks associated with the Department's current lending practices and strengthen the internal control over administration of the Small Craft Harbor and Recreational Marina Loan Programs. Appendix A summarizes suggestions for strengthening the loan process, and Appendix B provides an overview of the current loan process.

Recommendation 1: Develop Detailed Written Policies and Procedures

To ensure program objectives are met, develop detailed procedures for the following:

- Review, selection, and approval process for potential loan recipients.
- Interest rate policy for inclusion in contract terms and conditions.
- Loan disbursement and repayment process for approved loans.
- Monitoring of projects and loan status for current borrowers.
- Loan tracking process for current, pending, or reverted/cancelled loans.
- Close-out process for project completion and full repayment of the loan.
- Accounting file numbering process.

While the Department's Contract Administrators Manual (CAM) provides an overview of the Small Craft Harbor and Recreational Marina Loan Programs, it does not provide detailed procedures regarding program implementation. As a result, key person dependency developed to ensure the required activities were performed. When several of these key staff left the Department, this knowledge was lost and the remaining staff determined what procedures should be followed. This resulted in inconsistent, inefficient, or inadequate processes and a lack of communication among departmental staff. Detailed procedures would have provided a clear understanding of the processes, requirements, and individual roles and responsibilities. Furthermore, Section 20050 of the State Administrative Manual (SAM) states flowcharts, narratives, desk procedures, and organizational charts should be maintained to regulate and guide operations.

Recommendation 2: Improve Interdepartmental Communication

To ensure project information is consistent with Department guidelines and requirements and communicated among executive, accounting, and program staff, implement the following:

- Periodic meetings with executive, accounting, and program staff to discuss fiscal and program status of the loans.
- The Accounting Unit should provide the monthly expenditure, encumbrance, and collections reports to executive and program staff.
- Maintain the project blog on the Department's website.

Without proper communication, pertinent information regarding loans could be lost or omitted, which could lead to inaccurate billing, disbursements, loan balances, etc. For example, we identified $14.1 million of encumbrances for contracts with project completion dates that had already passed. Additionally, fiscal and project information maintained was not always consistent.

Recommendation 3: Improve Loan File Maintenance

To ensure the accuracy and completeness of critical loan information, retain the following:

- Updated amortization schedules (T-Value)
- Events log
- Invoices
- Disbursement and repayment log
- Correspondence and management decisions
- Cross-references to contract amendments

The Harbors and Navigation Code Section 71.4 (b) states loans should be repaid in accordance with a loan contract agreement. Of 73 accounting files reviewed, we observed 6 loans (8 percent) with changes to interest rates or loan terms without fully executed contract amendments on file. In addition, in some accounting files the loan disbursement and repayment logs reflected incorrect total loans disbursed and repaid. As a result, funds could be incorrectly disbursed, incorrect amounts billed, and loan balances incorrectly calculated.

Recommendation 4: Strengthen Safeguarding of Assets

To ensure the state's assets are adequately safeguarded, consistently perform the following:

- Background checks to assess the credit risk associated with each loan recipient.
- Develop a risk based approach to prioritize and perform site visits.
- Review loan recipients' annual financial reports to evaluate continuing ability to repay the loan and whether the project is progressing according to the contract agreement.

The Department does not perform background and credit checks for potential loan recipients or site visits for loan recipients. Moreover, the Department does not review the loan recipient's annual financial reports. Currently, the Department has over $2.9 million in delinquent loans. The Office of the Comptroller of the Currency's[1] Loan Portfolio Management Handbook states before making a credit commitment, consider the borrower's overall financial condition and resources and establish a system of independent, ongoing credit review. The long-term financial stability of a loan recipient provides assurance that the state's investment is protected and recoverable.

[1] The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises all national banks.

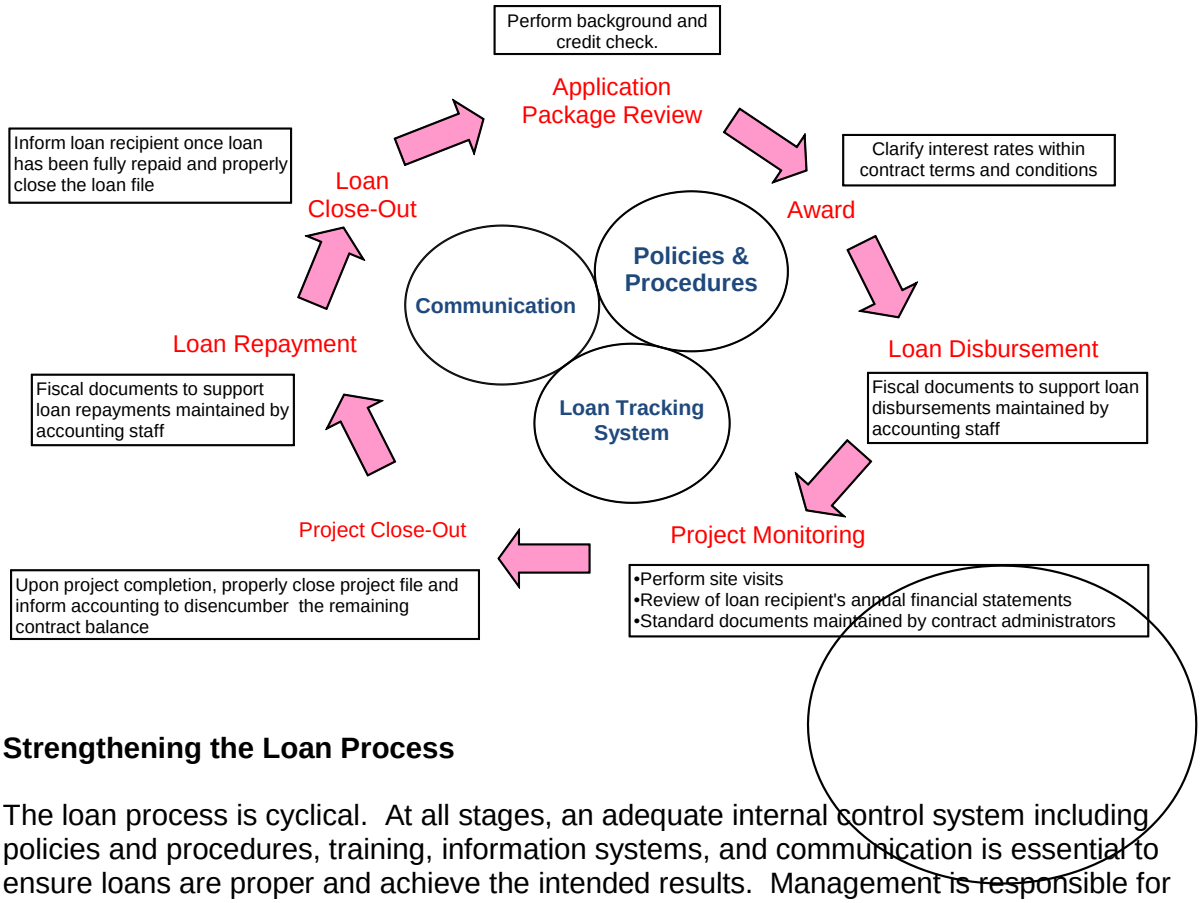
Recommendation 5: Implement an Integrated Loan Tracking System

The Department should implement an integrated loan tracking system to efficiently and effectively track the following:

- Total outstanding public and private loan population
- Loan recipient's name and contract number
- Project name and anticipated completion date
- Current loan balances
- Current amortization schedules
- Principal and interest paid
- Outstanding interest and principal due
- Loan terms and interest rates
- Encumbered funds
- Funds eligible to be disencumbered
- Project close-out and reconveyance information
- All relevant correspondence affecting the loan

The Department's current loan tracking system does not have the capabilities to maintain a loan portfolio with readily available information such as outstanding loan population or outstanding loan balances. With 170 loans totaling over $351 million, a fully integrated tracking system would provide timely access to loan data, increase efficiency, and identify loans which may be at risk.

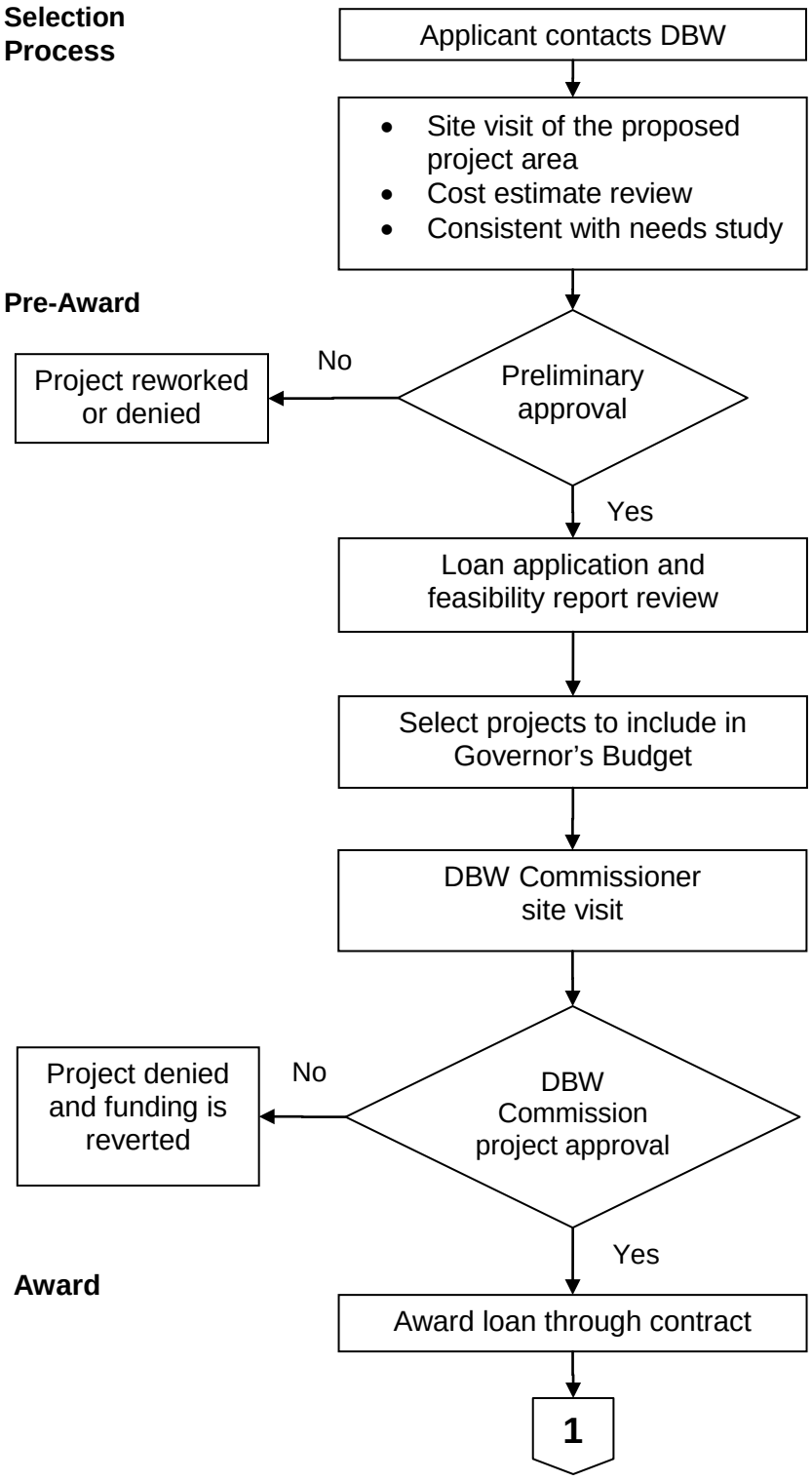
Strengthening the Loan Process



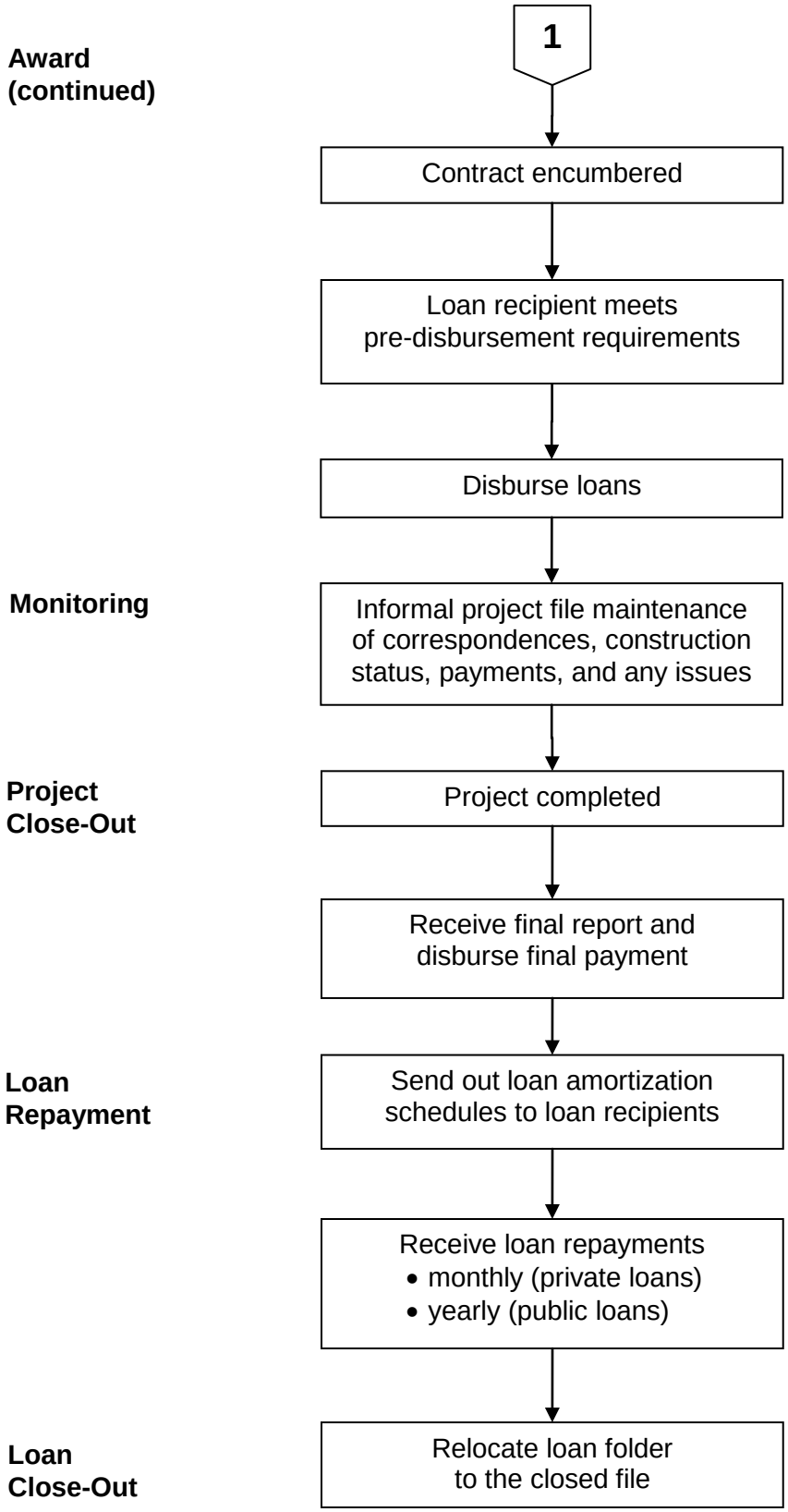
Strengthening the Loan Process

The loan process is cyclical. At all stages, an adequate internal control system including policies and procedures, training, information systems, and communication is essential to ensure loans are proper and achieve the intended results. Management is responsible for establishing and maintaining these controls.

Current Loan Process



Current Loan Process (Continued)



STATE OF CALIFORNIA - CALIFORNIA NATURAL RESOURCES AGENCY ARNOLD SCHWARZENEGGER, *Governor*

DEPARTMENT OF BOATING AND WATERWAYS
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May 12, 2010

Mr. David Botelho, Chief
Department of Finance
Office of State Audits and Evaluations
300 Capitol Mall, Suite 801
Sacramento, CA 95814

Dear Mr. Botelho:

Thank you for the thorough loan portfolio compilation and assessment of the Department of Boating and Waterways (DBW) Small Craft Harbor and Recreational Marina Loan Programs.

The Department's responses to the five main recommendations included in the report follow.

Recommendation 1: Develop Detailed Written Policies and Procedures

Since the review was conducted, DBW has filled a vacant management position to oversee the Small Craft Harbor and Recreational Marina Loan Programs. This change in management brings a nearly two decade background in public infrastructure loans and grants and state auditing. DBW is committed to making process improvement a priority. Detailed written policies and procedures are currently under development. These efforts include documenting a detailed outline of the overall loan process, identifying sub-process, developing detailed procedures with end-user input, and standardizing key documents. Of the seven areas specifically identified in this recommendation, five are in draft and discussion stages, and two are in concept and discussion stage.

Recommendation 2: Improve Interdepartmental Communication

The Boating, Loan, Information and Planning Unit and DBW's Accounting Office are working closely together to improve communication. The loan procedures under development include standard letters copying DBW's Accounting Office and Public Information Office. This program enhancement is intended to produce an efficient and documented method of communication. This information exchange will serve to ensure pertinent information concerning loans is conveyed in a timely way, resulting in timely disencumbrances and shared knowledge of changes in loan status. Based on detail provided through this review, a clean-up effort is under way to assure required disencumbrances occur and to preserve the integrity of the Harbors and Watercraft Revolving Fund. Regular meetings between the Loan Program and the Accounting Office have begun to reconcile loan status on an ongoing basis.

Recommendation 3: Improve Loan File Maintenance

The loan portfolio compilation and assessment information provided by your staff will be instrumental in improving loan file maintenance. The Department's Loan Program

Manager and Accounting Manager are already working together, utilizing available resources, to identify necessary improvements. Additional efforts are being made to standardize the layout of the central files and consolidation of the loan files. DBW is confident that the Process Outline mentioned in Recommendation 1 above, identifies key control points and event. Standard key documents including correspondence of management loan decisions will boost program integrity and while providing a record of activity. Additionally, DBW management will not authorize disbursements without sufficient competent supporting documentation.

Recommendation 4: Strengthen Safeguarding of Assets

The Department is currently updating its underwriting requirements to comply with recent changes in law. The Department is also reviewing loan and grant policies and procedures of other state agencies, and is networking with these agencies to ensure a strong program while upholding the public trust. Files are under review to ensure timely analysis of Audited Financial Statements on all active loans. Loan staff and management are analyzing projects and scheduling site visits. These site visits are being documented in Site Visit Reports. In addition to the benefit of the individual project, these documented reports will also serve as a rational basis and method to determine risk/benefit of future site visits to other projects.

Recommendation 5: Implement an Integrated Loan Tracking System

The Department included in its IT Infrastrucure Plan a proposal for an integrated database for its loan, grant, and other programs. This system will replace fragmented stand-alone systems, reduce manual work steps, and to develop capacity to collect administrative and program data, monitor department's programs, and analyze data. DBW anticipates initiating an IT assessment and feasibility study report in FY 10/11. In the interim, DBW will continue to conduct regular fiscal reconciliation using currently available software, and to implement written procedures and consistent written communication.

Many of your recommendations have already been implemented, and I am confident that the remaining recommendations will be implemented by August 15, 2010.

Please contact me if you have any questions at (916) 263-0782.

Sincerely,

Original signed by:

Lucia C. Becerra
Acting Director