DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

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December 22, 2009

DEPARTMENT NAME: Department of Finance
ORGANIZATION CODE: 8860

INTRODUCTION:

In accordance with the Financial Integrity and State Managers Accountability (FISMA) Act of 1983, the Department of Finance (Finance) submits this report on the review of our systems of internal control for the biennial period ended December 31, 2009.

Should you have any questions please contact Fred Klass, Chief Operating Officer, (916) 445-4923, Fred.Klass@dof.ca.gov.

BACKGROUND:

Finance's mission is to serve as the Governor's chief fiscal policy advisor, promote responsible resource allocation through the state's annual financial plan, and ensure the financial integrity of the state. The Director of Finance is responsible for carrying out the Department's mission with emphasis on maintaining a fiscally sound and responsible Administration. The Director is appointed by the Governor and sits as a member of the Governor's cabinet and senior staff. In addition, the Director sits on numerous boards and commissions which directly impact a broad array of state activities.

Finance's principal functions are to:

- Establish appropriate fiscal policies to carry out the state's programs.
- Prepare, enact, and administer the State's Annual Financial Plan, which the Governor is required to present by January 10 of each year in accordance with the State Constitution.
- Analyze legislation which has a fiscal impact.
- Develop and maintain the California State Accounting and Reporting System.
- Participate, as one of four Partner Agencies, in the design, development, implementation, utilization, and maintenance of the integrated Financial Information System for California (FI$Cal) special project.
- Monitor/audit expenditures by state departments to ensure compliance with law, approved standards, and policies.
- Develop economic forecasts and revenue estimates.
- Develop population and enrollment estimates and projections.

Finance has a strong history of laudably fulfilling its responsibilities. That history of performance has garnered respect from successive administrations and legislatures and earned it a reputation as a venerable institution. The foundation of this reputation is a set of core values that guide the actions of the employees who, collectively, are the Department of Finance.

Management leads by example, conducting day-to-day operations with the highest professionalism. Roles and responsibilities are well defined. Strong lines of authority, control, collaboration, and communication are fostered and maintained throughout seven major units and numerous sub-units within Finance.

VACANT POSITIONS:

We have reviewed our records for fiscal years 2007-08 and 2008-09 and determined Finance is in compliance with Government Code §12439.

RISK ASSESSMENT

The risk assessment was performed using a control self-assessment process facilitated by staff from the Office of State Audits and Evaluations (OSAE). Through a series of meetings over several weeks, the Chief Operating Officer and Program Budget Managers (Executive Management) identified risks that could adversely impact Finance's achieving its mission. OSAE staff used a combination of surveys, interviews, facilitation techniques, and Option Finder voting technology to assist management to determine significant organizational risks.

Risk statements were prepared, revised, and then ranked, based on both the severity and possibility of occurrence. Mitigating controls were evaluated for all risks, regardless of ranking. Executive Management then met with all Capitol Office staff (Director, Chief Deputies, Deputies, and Chief Counsel) to review, discuss, and vet the identified risks and controls.

For most of the risks identified, corresponding existing controls were identified that, if working as intended, would provide reasonable assurance that risks would be mitigated. For other risks, management identified controls that, once established, would help mitigate risks. In some instances, the risks facing Finance are outside its control, and therefore, management has made an informed decision to accept the consequences and likelihood of those risks.

Finance management is implementing a system of continuous assessment and evaluation of its control structure. Throughout each subsequent reporting cycle, management will reassess the risks it faces and evaluate the controls identified to mitigate those risks. While a number of risks were identified, this review focuses on the highest ranked risks and a sample of mitigating controls.

EVALUATION OF RISKS AND CONTROLS:

As part of the Governor's Administration, Finance operates in a dynamic and unique environment. Finance is often required to rapidly adjust as available resources increase or decrease, and swiftly shift duties as priorities and the Administration itself changes. Many of the risks identified focus around this dynamic and unique environment and are further heightened by California's current economic and budgetary challenges.

The following significant risks are presented in this report.

- External requests often demand quick turnaround on work products, research, and advice. Short timeframes tend to necessitate that work be done by the most experienced staff. This can result in less experienced staff not being afforded the opportunity to become engaged in or gain experience from important and challenging work and policy development efforts.

- The mainframe legacy systems in place for the annual budget preparation were not designed for the extremely volatile circumstances of today's environment. They are not capable of providing detailed timely information necessary for budget policy decisions. Nevertheless, they are essential to completing the technical components of producing a Governor's Budget. Therefore, the use of Excel spreadsheets and other IT systems have been developed over the years to supplement these antiquated systems. The data generated from these supplemental systems often serve as the basis for vital decisions. However, all of the systems must ultimately be integrated and their fiscal data tied out across each other. This requires an intensive manual effort that introduces many opportunities for errors. The cost in staff time and effort to reconcile the systems is very significant. With very few exceptions, this manual effort has resulted in complete sets of reconciled fiscal information that is sufficient for informing policy decisions. However, it comes at a significant cost to the Department by contributing to employee burn out and increased costs for overtime.

- Finance relies on specific individuals with significant knowledge and expertise in key areas making the Department vulnerable if they leave, retire, or are temporarily absent. Additionally, continuing staff turnover due to promotional opportunities or the pursuit of a different work/life balance, limits Finance's ability to maintain knowledge and expertise.

- To address the work/life balance for staff, the department has made a substantial effort to reduce overtime among budget line analysts. The result is a significant amount of workload has shifted to mid and upper-level management. This increases the potential for fatigue and turnover among those staff.

- Highly technical, complex forecasting processes and various forecasting models introduce inherent risks that could lead to imprecise forecasts.

- Absorbing the responsibilities for special projects such as the American Recovery and Reinvestment Act, the Commission on the 21st Century Economy, and FI$Cal requires allocation of Finance's limited resources. Although additional funding is secured for some special projects, successfully completing them still requires the use of our more experienced staff, leaving our less experienced staff to maintain day-to-day operations.

While Finance management identified a number of mitigating controls, OSAE tested the following significant controls as they addressed multiple risks:

- *Extensive training curriculum* – In an effort to develop employees' knowledge and abilities, ensure promotional readiness, instill professionalism and empowerment, and encourage thoughtful and creative interaction with departments, Finance administers an extensive training program. This facilitates Finance's ability to sustain functionality in the current environment and surmount the challenges of turnover among key staff.

  To test this, OSAE gained an understanding of Finance's training policies, compared a sample of positions' training curriculum to the knowledge and abilities listed in the State Personnel Board job specifications, administered a survey to staff, and verified that a sample of employees completed training according to their planned curriculum.

Finance's training program is satisfactory to develop sufficient knowledge, skills, and abilities for employees. Ninety-three percent of survey respondents either agreed or strongly agreed that staff regularly attend training related to the successful achievement of Finance's objectives. Additionally, Finance's core values of teamwork, respect, integrity, problem solving, and expertise are emphasized and incorporated into the training curriculum. Although Finance's training program is satisfactory, the sample of employees had only completed an average of 75 percent of their planned curriculum. To ensure Finance's training program is working as intended, employees should complete all training identified in their respective plans.

- *Stringent hiring practices* – Finance's stringent hiring practices increase the likelihood that only the most qualified employees are hired. Finance accomplishes this by a variety of evaluation techniques designed to elicit desired characteristics, including but not limited to, oral interviews, math and writing exams, analytical tests, and reference checks. The probationary period is a continuation of the hiring process that further evaluates an employees' ability to meet performance standards. Similar to the extensive training curriculum, Finance's hiring practices facilitate its ability to sustain functionality in the current environment and surmount the challenges of turnover among key staff.

  To test this, OSAE gained a general understanding of Finance's hiring process. OSAE then selected a sample of positions to evaluate whether the hiring process would determine the adequacy of a candidate's qualifications and desired characteristics. Additionally, OSAE selected a sample of employee separations that occurred during the probationary period to conclude on the effectiveness of the initial hiring process and evaluate whether the probationary period is reasonable to ensure qualified staff is retained.

  Finance's hiring practices are adequate to increase the likelihood that only the most qualified employees are hired.

- *Cross training* – The seven major units and numerous sub-units within Finance conduct a number of critical activities that require specialized knowledge and expertise. To protect against the inability to carry out these critical activities should specific individuals leave, retire, or are temporarily absent, Finance cross trains employees.

  To test this, OSAE interviewed a majority of Assistant Program Budget Managers representing 15 sub-units to identify the critical functions within their unit, the positions that perform those critical functions, and their policies related to cross training and succession planning.

  In a majority of the sub-units, cross training was adequate to carry out critical activities should key employees leave. However, in some of the sub-units, cross training for key positions and/or activities requiring specific expertise should be improved. Assignment rotations are not occurring as desired and/or desk procedures have not been developed.

- *Overtime management* – To address the high turnover among budget line analysts, Finance's management has made significant efforts to reduce overtime worked by those staff. To evaluate whether this reduction in overtime was an effective control in reducing turnover, OSAE evaluated overtime and turnover trends and administered a survey to budget unit management.

Budget line analysts showed a significant decrease in overtime from fiscal year 2007-08 (9982 hours) to 2008-09 (5410 hours). Turnover for budget line analysts also decreased over this time period. A consequence of reducing overtime among budget line analysts is that a significant amount of workload has shifted to mid and upper-level budget unit management. This increases the potential for fatigue and turnover among those staff. However, analysis shows that turnover for budget unit management has decreased between July 1, 2007 and October 9, 2009.

Budget unit management is not required to track or report overtime worked. Therefore, OSAE administered a survey to evaluate overtime trends. Respondents who had been in their management level positions for three or more years were asked if they have seen an overall increase, decrease, or no change in overtime for budget unit management. Thirty-eight percent responded they have seen an increase in overtime, 32 percent reported a decrease, and 30 percent reported no change.

Although turnover for budget unit management and budget line analysts has decreased, factors other than Finance's overtime policy may have contributed to the reduction. Examples include state hiring freezes, the state's budgetary crisis, or the lack of private sector job opportunities due to the economic downturn. The overtime data examined covered fiscal years 2007-08 and 2008-09. These two years were significantly different based on when the budget was enacted, variances in the number of budget exercises requested, and the increased complications to the budget process from increased deficits. OSAE will retain and continue to collect necessary data so a more meaningful evaluation can be completed at a later date.

- *Substantial data verification processes* – Finance's Budget Operations Support (BOS) unit in conjunction with the other budget units within Finance performs substantial data verification. This added data verification is crucial when the budget process deviates from the norm and financial reports are derived from spreadsheets rather than typical mainframe systems. The process includes multiple layers of management review, ensuring the most current version is tracked and used, and multiple reconciliations. This data verification process helps mitigate the risk that vital decisions will be made based on inaccurate information.

  To evaluate the data verification process, OSAE gained an understanding of the processes in place at BOS and selected a sample of budget units to evaluate their involvement in the process. Additionally, OSAE selected a budget exercise to test whether version tracking controls were working as intended, reconciliations were performed, and the final product traced to source documents.

  Until improved systems are implemented for the annual budget preparation, the data verification process provides reasonable assurance that information provided by Finance can be relied upon and used as the basis for vital decisions.

A majority of the controls examined are effective measures in mitigating risks and are working as intended. However, we determined cross training for key positions and/or activities requiring specific expertise should be improved. Additionally, employees are only completing a portion of the training identified in their training curriculum. Finance will address these issues in our corrective action plan.

CONCLUSION:

I certify that our systems of internal controls are adequate to mitigate potential threats identified in the Evaluation of Risks and Controls Section above.

Michael C. Genest, Director
California Department of Finance

Enclosure

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