



PERFORMANCE REVIEW OF EdFUND

An Analysis for the California Student Aid Commission

April 2005

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Public Works LLC
Eric B. Schnurer, President
1690 East Strasburg Road
West Chester, PA 19063
610-296-9443
www.public-works.org

West Coast Office
6778 Park Riviera Way
Sacramento, CA 95831
916-716-0159

Introduction

The California Student Aid Commission (CSAC) and its nonprofit loan auxiliary, EdFUND, administer financial aid and loan guarantee programs for students attending public and private universities, colleges, and vocational schools. Signed into law on September 21, 2004, Assembly Bill 2122 (Chapter 657, Statutes of 2004) directed CSAC to “conduct regular performance evaluations of the operation of auxiliary organizations in furtherance of its fiscal and fiduciary responsibilities for approved programs.” (California Education Code Section 69522(c)(2).)

As part of this regular performance evaluation process, the CSAC retained **Public Works LLC**, a national public policy firm that has conducted agency and statewide performance reviews, to review EdFUND’s organizational structure, internal administrative processes, management functions, and workforce development practices, and to assess their effectiveness. Given the limitations of time and resources allotted to this performance review, as will be discussed in more detail below, and because this was the first performance review undertaken in response to this legislation, we necessarily have approached this review as a beginning point for further analysis and consideration of issues, not a definitive end or conclusion.

Background

CSAC is California’s primary provider of grant aid to postsecondary students. Celebrating its 50th year anniversary in 2005, CSAC’s primary programmatic responsibilities include operation of the Cal Grant program, which will distribute about \$759 million to California’s college students during the FY 2004-05 school year, and several targeted state scholarship and loan forgiveness programs, as well as serving as a federally designated student loan guaranty agency.

CSAC currently operates at no cost to California taxpayers. Since July 2003, CSAC’s entire administrative budget has been funded through revenue generated by its non-profit auxiliary corporation, EdFUND. Its 15-member Commission¹ oversees the activities of CSAC, as well as EdFUND, as set forth in state law.

EdFUND was organized by CSAC as a 501(c)(3) public benefit corporation pursuant to legislation authorizing CSAC to establish a non-profit auxiliary to administer all activities associated with its participation in the Federal Family Education Loan (FFEL) program. EdFUND began operations on January 1, 1997. EdFUND is managed

¹ Throughout this report, we refer to the California Student Aid Commission, as an organization, as “CSAC.” We refer to the group of governing commissioners as the “Commission.” Eleven commissioners are appointed by the Governor, two by the Speaker of the Assembly, and two by the Chair of the Senate Rules Committee.

by a nine-member Executive Management Team and governed by a 13-member Board of Directors, which is appointed by CSAC.²

EDFUND has grown to become the nation's second largest provider of student loan guarantee services under the FFEL Program, among government-run as well as privately-run, non-profit agencies. EDFUND offers students a wide range of financial aid and debt management information while supporting schools with advanced loan processing solutions and default prevention techniques. Operating as an auxiliary corporation of CSAC, EDFUND processes more than \$7.1 billion in student loans annually (including consolidation loans) and manages a portfolio of outstanding loans valued at \$21 billion. Its mission statement conveys the zeal and purpose of the organization as a whole: "EDFUND is dedicated to maximizing benefits to borrowers by being the premier service provider in the student loan industry."

That positive sense of mission is supported by many outstanding accomplishments on behalf of students, schools, and California as a whole, including:

- EDFUND guaranteed more than \$7.1 billion in student loans in FY 2003-04, including consolidations, an increase of 28 percent in one year.
- The dollar volume of Stafford and PLUS guarantees grew to \$5.7 billion in FY 2003-04, a one-year increase of 29 percent.
- For the first time in its history, EDFUND guaranteed more than one million non-consolidation loans in one fiscal year. EDFUND guaranteed more than 1.2 million non-consolidation loans in FY 2003-04, a 26 percent increase in one year.
- Consolidation loan volume increased to \$1.4 billion in FY 2003-04, a 24 percent increase over the previous fiscal year.
- EDFUND continues to grow its loan dollar volume in California, increasing it by 12 percent in FY 2003-04.
- EDFUND continues to expand its presence and business beyond California. More than 77 percent of the \$1.3 billion annual increase in non-consolidation loans came from schools in other states. The out-of-state loan volume rose 50 percent in FY 2003-04. For the first time in EDFUND's history, the loan volume (\$3 billion) and number of loans (690,539) from schools in other states exceeded the loan volume (\$2.7 billion) and number of loans (546,902) from schools in California.
- EDFUND has unveiled a number of client-friendly tools that enable schools to track borrower loans and contracts, conduct entrance and exit

² The President of EDFUND serves as a non-voting ex-officio representative to the Board.

counseling, and develop better default prevention plans. Other tools provide borrowers with financial planning and loan debt tracking capabilities.

The Federal Family Education Loan Program

EdFUND's reason for existence is directly tied to the administration of the FFEL Program on behalf of CSAC. EdFUND's revenues, and thus CSAC's funding, are derived almost exclusively from federal sources. For the time being, in the words of one member of the EdFUND Executive Management Team, "EdFUND is a one-trick pony." An understanding of this federal loan program therefore is important to this analysis.

Part B of Title IV of the Higher Education Act of 1965, as amended, includes the FFEL Program, formerly the federal guaranteed student loan program. The FFEL Program offers guaranteed and insured loans including:

- **Subsidized federal Stafford loans:** Federal reinsurance and interest subsidies on loans for eligible undergraduate, graduate, and professional students. These subsidies are based on need and ability to pay.
- **Unsubsidized federal Stafford loans** (guaranteed student loans): Reinsurance on loans for graduate and professional students, as well as independent undergraduate students. These are not need-based loans, but can be used to offset education costs.
- **Federal PLUS loans:** Federal reinsurance on loans to parents of dependent undergraduate students to help them meet their dependent's cost of education. Like unsubsidized federal Stafford loans, these are not need-based, but can be used to offset education costs.
- **Federal consolidation loans:** These allow a borrower to consolidate multiple student loans into a single loan during repayment.

FFEL Program loans are available to students attending institutions of higher education, vocational and technical schools, business and trade schools, and some foreign institutions. The loans are insured by a State or private, nonprofit guaranty agency and are reinsured by the federal government.

The FFEL Program is administered through State and private nonprofit guaranty agencies that insure loans directly, collect defaulted loans, and provide various services to lenders. In California, CSAC is the federally designated student loan guaranty agency. According to the U.S. Department of Education, the federal government supports guaranty agencies by providing loan advances and reinsurance payments for borrower default, death, disability, and bankruptcy. The federal government also pays administrative cost allowances to guarantee agencies under Section 458 of the Higher Education Act, as well as an interest subsidy to lenders, based on the borrower's

interest rate, on behalf of Stafford loan student borrowers while they are in school and during certain grace and deferment periods.

Because the federal government establishes the fee structures, reimbursement rates, and other revenue streams of the FFEL Program, the factors that will contribute significantly to EdFUND's continuing success in the guaranty industry include superior client services, which increases the likelihood that schools will select and stay with EdFUND over other guaranty agencies; a willingness to forego the one percent loan guarantee fee, which saves students and parents money while making EdFUND a more attractive loan partner to schools; outstanding performance in the Voluntary Flexible Agreement, an agreement with the U.S. Department of Education that has enabled EdFUND to increase income by exceeding performance-based incentives for default aversion; and program efficiency. Each of these factors becomes increasingly more important as the federal government continues to reduce fees and payments, as it has in recent years, and seeks to renegotiate the Voluntary Flexible Agreement.

An important part of CSAC's on-going oversight of EdFUND, therefore, should be to ensure that the organization operates at maximum efficiency and effectiveness in order to continue being successful in an increasingly competitive, highly regulated industry. This performance review and subsequent annual performance reviews can contribute to those efforts.

CSAC Oversight Mandate

Section 69522 (a)(1) of the Education Code states that CSAC

may establish an auxiliary organization for the purpose of providing operational and administrative services for the commission's participation in the Federal Family Education Loan Program, or for other activities approved by the commission and determined by the commission to be all of the following:

- (A) Related to student financial aid.
- (B) Consistent with the general mission of the commission.
- (C) Consistent with the purposes of the federal Higher Education Act of 1965 (Public Law 89-329) and amendments thereto.

EdFUND's authorizing legislation retained CSAC's role as the official guarantor while granting EdFUND the authority as the guaranty service provider to operate under private sector standards and to create new loan products and services. This balancing act was designed by State policymakers to enable EdFUND to pursue its public service mission in a highly competitive private sector environment with a greater degree of flexibility. Specifically, EdFUND was designed to compete with other guaranty agencies by offering comparable private sector salaries and benefits to attract talent, to hire at-will

employees to avoid cumbersome State civil service rules and procedures, and to be free from State procurement requirements.

Despite the creation of its auxiliary,³ CSAC remains responsible for overall financial aid program administration. Pursuant to California Education Code Section 69522:

(c)(1) The commission shall maintain its responsibility for financial aid program administration, policy leadership program evaluation, and information development and coordination. The auxiliary organization shall provide operational and support services essential to the administration of the Federal Family Education Loan Program and other permitted activities that are related to student financial aid, if those services are determined by the commission to be consistent with the overall mission of the commission.

CSAC can exert its oversight authority over EdFUND in three key manners:

- CSAC is responsible for nominating and appointing the members of and determining most of the composition of the EdFUND Board of Directors, pursuant to Education Code Section 69525.
- CSAC, in consultation with the Department of Finance and the EdFUND Board, is required to:
 - Institute a standard accounting and reporting system for the management and operations of EdFUND. (Section 69526(b)(1).)
 - Implement financial standards that will ensure the fiscal viability of EdFUND. These standards “shall include proper provision for professional management, adequate working capital, adequate reserve funds for current operations and capital replacements, and adequate provisions for new business requirements.” (Section 69526(b)(2).)
 - Institute procedures to ensure that EdFUND transactions are consistent with the mission of CSAC.
- According to its authorizing legislation, EdFUND’s operations “shall be conducted in conformity with an operating agreement approved annually by the commission.... The operations of the auxiliary organization shall be limited to services prescribed in that agreement.” (Education Code Section

³ We have not found adequate explanation of the term “auxiliary” in the legislation or any other document provided to us, as will be discussed in Chapter 7.

69522(d)(1).) The operating agreement attempts to set forth the roles and responsibilities of CSAC and EdFUND. The current operating agreement became effective on October 1, 2002, and has been amended slightly each year since then.

As part of its general oversight responsibilities, CSAC is required to report to the Legislature on April 1 of each year regarding the operation of EdFUND. This report must include the following information:

- A description of the services provided by EdFUND.
- EdFUND's annual budget, funded activities, and personnel, including the sources of revenue available to fund its operations.
- Descriptions of changes made in the delivery of loans to California students and enhancements to the programs and activities administered by CSAC.
- The level of compensation of managers and executives of EdFUND.
- Specific descriptions of the action taken, the costs incurred, and the revenues realized by EdFUND in disbursement services, loan servicing and repayment, secondary market, and private lender activities undertaken pursuant to purpose as CSAC auxiliary. (Education Code Section 69529.5.)

Performance Review Oversight Authority

As noted above, recent legislation, Assembly Bill 2122, requires CSAC to undertake "regular performance evaluations of the operation of auxiliary organizations in furtherance of its fiscal and fiduciary responsibilities for approved programs."

(c)(2) The implementation and effectuation of the auxiliary organization shall be carried out so as to enhance the administration and delivery of commission programs and services. The commission shall conduct regular performance evaluations of the operation of auxiliary organizations in furtherance of its fiscal and fiduciary responsibilities for approved programs.

This legislation essentially codified CSAC's already-existing authority to conduct performance reviews of EdFUND, as set forth in the Operating Agreement between CSAC and EdFUND:

Commission Oversight and Audits. The Commission may, in its discretion, perform periodic contract performance reviews and audits of

EDFUND's operations in order to evaluate the efficiency and effectiveness of EDFUND's administrative and operational systems, including analyzing EDFUND's compliance with this Agreement, applicable state and federal laws and regulations and with Commission and EDFUND internal policies. EDFUND shall provide access to the Commission or a designee of the Commission to its premises and staff for monitoring, review, and testing of EDFUND's operations. The Commission shall provide reasonable notice to EDFUND prior to any such reviews and audits.

Scope of Review

To assist in these efforts, CSAC retained **Public Works** to perform a review of the current EDFUND organizational structure and evaluate its effectiveness, including:

- Reviewing the financial reporting structure, assessing the adequacy of current reports, and identifying any redundancies in divisions or costs between CSAC and EDFUND;
- Reviewing a sample of legal documents such as vendor contracts and employee contracts to assess the adequacy of the documentation and compliance with EDFUND policies and making any recommendations or important changes;
- Assessing Division efficiency and programs (Legal Services Division and Finance & Administration Division);
- Determining the level of promotional opportunities that are available to EDFUND's civil service workforce during the past three or four years, such as performing the following:
 - Identifying the number of promotions that have been granted to civil service employees;
 - Reviewing the individual interview processes for previous promotional opportunities;
 - Comparing the promotional opportunities that have been/are available to EDFUND's civil service workforce to those that have been/are available to EDFUND's at-will workforce; and
 - Identifying the number of new at-will hires versus internal civil service promotions.
- Reviewing the process and metrics of the EDFUND Executive Management Team, including management salaries, skills and experience, and performing a comparative analysis of similar organizations to determine the reasonableness of the current process.

It is important to observe from the outset that a performance review is different from an audit. For example, the recent California Performance Review defined its efforts as “an assessment of program necessity and effectiveness.”⁴ An effective performance review of an organization requires an analysis of a wide array of information, data, processes, and organizational structures. Unlike an audit, which focuses on aligning budgetary line items to be sure that numbers add up, a performance review asks underlying, big-picture questions regarding the management, direction, efficiency, and effectiveness of an organization. Although we certainly want to be sure that numbers indeed “add up,” this performance review is more focused on asking whether the numbers make sense – and whether other numbers might better enable CSAC and EdFUND staff, as well as State policymakers, to guide the delivery of better services to clients of both organizations.

The general methodology employed in this review has been used in performance reviews undertaken by the federal government’s National Performance Review, and states ranging from Texas to New Mexico to California itself. As part of this process, we reviewed relevant portions of the California Education Code regarding the establishment of CSAC and EdFUND and the delineation of their respective roles and responsibilities. We requested and examined hundreds of documents, including the CSAC and EdFUND Operating Agreement, EdFUND Business Plans, EdFUND’s policies and procedures, internal memoranda and meeting notes, contracts, reports, and audit reports, among many others. The majority of data presented in this analysis reflects information provided to **Public Works** upon written request. Those written requests and responses from EdFUND and CSAC can be obtained from CSAC staff. We supplemented this data with some background information prepared by external sources, such as the U.S. Department of Education, the California Department of Finance, the Legislative Analyst’s Office, and the Bureau of State Audits. Finally, we interviewed each member of the EdFUND Executive Management Team, as well as other EdFUND and CSAC employees, regarding their specific roles and responsibilities and solicited their comments and concerns.

⁴ California Performance Review, Vol. 3, *Keeping the Books: California’s Budget, Financial, and Performance Review* (2004).

EDFUND **Concerns Regarding Scope and Methodology of Review**

We were mindful specifically of the EDFUND Executive Management Team's concerns regarding this performance review. Although we do not believe that an entity subject to review should dictate the terms or scope of that review, we considered very carefully the list of critical elements for a meaningful performance review that were supplied by the EDFUND Executive Management Team. These included:

- Performance goals or standards that will be used to measure EDFUND should be established and communicated in advance.

By and large, this performance review focused on examining the performance goals and standards that EDFUND itself promulgates and uses to measure its own performance, such as its Operating Dashboard. In other instances, we have compared EDFUND policies and procedures with those found elsewhere in the public and private sectors.

- A performance review should be conducted through a fair and objective review process.

The process through which we were allowed to communicate with EDFUND staff and request information was cumbersome but designed by CSAC presumably to ensure that information requests and subsequent document delivery could be tracked and did not fall through any bureaucratic cracks. This enabled all parties – CSAC, EDFUND, and consultants – to know the directions in which inquiries were heading, but did not seem to us to engender much of a sense of trust or unified purpose. The performance review suffered from the mantra of “Please put that request in writing,” in that we would have felt more comfortable just picking up the telephone and asking questions rather than trying to craft perfectly honed written requests and setting up formal interviews. Everyone adhered to the process, but that process, in our view, seemed unnecessarily restrictive and did not encourage a free-flow of dialogue or information. In sum, it was structured more as an adversarial proceeding than a cooperative search for ways to enhance performance.

Although the five general areas of the performance review were delineated from the start by CSAC in its Request for Proposals, CSAC staff did not provide any direction as to what detailed information to examine, what sources of information to review, or even which personnel to interview. These were left to our own discretion. Nor did we indicate to CSAC where our analysis was heading; even our progress reports to CSAC focused strictly on process issues and did not disclose draft substantive information regarding the contents of the report or its analysis. This was done purposefully to avoid CSAC pointing our analysis in any particular direction. We simply followed the data. Neither did EDFUND try to influence the direction of our analysis. EDFUND staff produced data or

information in response to direct questioning or written requests for specific documents.

- The process should be designed to produce a thorough and meaningful report.

Not counting the periods during which work was ordered to be suspended because of disputes between CSAC and EdFUND, we had only 10 weeks of work to collect and review all of the data, with a few additional weeks to produce and refine the report. The process yielded thousands of pages of documents and more than two-dozen personal interviews. Despite the length of this report, this analysis could have gone deeper and more in-depth had we had more time and more open access to personnel, documents, and data. Future annual performance reviews, which should benefit from a more familiar and standardized process, as well as a full year in which to gather and analyze information, should seek to cover topics in greater detail. At the very least, both organizations will begin their performance review work with a similar library of documents, which was not the case at the outset of this effort. Nevertheless, we hope that the findings and recommendations contained herein will enable the Commission and EdFUND Board to work through some of the challenges that we identify and continue to improve the management and operations of both organizations.

- Clear roles and responsibilities should be established.

The consultants' roles and responsibilities in this process were established from the outset by the RFP. As the process for undertaking an annual performance review becomes standardized within both organizations, hopefully the Commission and EdFUND Board will work with their respective staffs to identify and designate appropriate roles and responsibilities among staff, executives, subcommittees, and oversight bodies.

- Sufficient notice and preparation time should be provided.

Assembly Bill 2122 was signed into law on September 21, 2004, and established the deadline for submission of an annual report regarding EdFUND activities to the Legislature as April 1, 2005. CSAC staff appears to have interpreted this report requirement to include information gleaned from this performance review and this interpretation seemed to drive the project deadlines. Based on the timelines that CSAC provided, the amount of time left to undertake the review was approximately three months. As already noted, the actual time for the collection and review of information was only about 10 weeks. We therefore made every effort to restrict requests for information to already-existing documents, publications, and data sets and to limit the amount of time staff would be asked to participate in interviews. In our view, future performance reviews should follow a more mutually agreed upon timeline and schedule to

serve the purposes of effective oversight with minimal disruption to the functioning and operations of the auxiliary.

- The performance review should not duplicate the work of other audits and reviews.

As noted earlier, a performance review is different from an audit. Although previous audit reports provided useful background information and context, their subject matter was not duplicated by the scope of this performance review. The findings and recommendations contained in this report may guide future audits and reviews of both organizations.

- Previously closed matters should not be subject to re-review and second-guessing.

There was no intent to re-review or second-guess previously decided issues. We did seek out information that provided background on decisions that were made previously in an effort to understand how certain operations and programs came to exist in their present form. In instances where previously decided issues may have bearing on the effectiveness and efficiency of EDFUND and/or CSAC, we have raised our concerns, if only to offer a new perspective and recommendations for additional discussion and consideration to improve operations and efficiency and minimize risks. Our intent in doing so is to flag what we believe to be potential issues and encourage both organizations to look forward in addressing them, not to look backwards. For example, in Chapter 2, we identify some potential concerns regarding particular contracting practices or adherence to policies and procedures. The raising of such concerns is not intended to trigger a wholesale review of all contracts, or to call into question the validity of the contracts we use as examples. The point is to encourage closer scrutiny of future contracts in the areas of identified concern.

- The scope of the review should be appropriate to the current issues of the audit period.

CSAC delineated the five general categories of review prior to the retention of **Public Works**. Within each category, much of the inquiry was restricted to data regarding the past year's performance. However, in some instances, additional data or reports were required from earlier years to ascertain trends and to show how certain data collection or analysis concerns can be compounded over time, affecting the measurement of organizational performance.

EDFUND explicitly states in its FY 2004-05 Business Plan, "We were formed and continue to focus on performance, achievement and accountability." EDFUND also states that, "We benefit from a higher standard of public accountability than our

competitors.”⁵ Given this outlook, **Public Works** hopes that our findings and recommendations will be welcomed by CSAC and EdFUND as part of both organizations’ ongoing efforts to improve performance, achievement, and accountability.

Structure of Report

This report discusses each of the five areas of review undertaken, as requested in the initial Request for Proposals issued by CSAC prior to the retention of **Public Works**. In each section, we provide some general background regarding the area of inquiry, identify potential or actual issues, provide general findings, and offer recommendations. We also offer some broader comments, findings, and recommendations that we believe could assist CSAC, EdFUND, and State policymakers generally to improve the operation and effectiveness of both organizations.

⁵ “Loan Program Business Plan 2004-05, Prepared for the Board of Directors of EdFUND and the California Student Aid Commission,” September 30, 2004, p. 6.

Financial Reporting

Scope of Review

CSAC asked **Public Works** to review EdFUND's financial reporting structure, assess the adequacy of current reports, and identify any redundancies in divisions or costs between CSAC and EdFUND. Due to the limited time for this review, we chose to focus our efforts on the financial reporting structure and the adequacy of current reports. During the course of interviews, we remained alert to obvious redundancies and costs but did not encounter any. We have identified specific elements of financial reports and operations that, due to a variety of factors, result in ineffective or inefficient practices

Methodology

Public Works reviewed financial operations at both CSAC and EdFUND, including:

- Cash management
- Business Service Operations
 - Printing
 - Property Management/ Asset Management
 - Security and Risk Management
- Budget
- Financial Reporting and Analysis
- Controller Operations
- Accounts Payable
- Accounts Receivable
- Imaging and Records Management
- Property and Facilities Operations
- Purchasing and Contracts
- Settlement Office Operations

Public Works conducted 19 in-person interviews and three follow-up conversations with front-line, supervisory, management and executive personnel. **Public Works** also extensively reviewed documents and reports prepared by both CSAC and EdFUND. Finally, **Public Works** researched best practices in financial operations and budgeting.

Budget Best Practices

In order to assess the adequacy of EdFUND's financial reports within the restricted timeframe, **Public Works** chose to focus on budget documents. **Public**

Works used the following generally accepted framework for evaluating EDFUND budget practices.

Role and Purpose of Budgets. Budgets serve as an essential tool for managing an organization, both fiscally and strategically, for the short-term and the long-term. The budget expresses an operational plan in financial terms. An operational plan identifies specific results to be accomplished within a given time period. Budgets should serve as tools, not as ends in themselves; the challenge is to have strategy driving the budget, rather than the budget driving strategy.

Repeatedly, the literature on effective budgeting emphasizes that even though budgets are designed to establish spending parameters for a limited period, budgets should strive to take a long-range perspective. In developing a budget, the National Advisory Council on State and Local Budgets (NACSLB) emphasizes the importance of developing a long-range financial plan so that decision-makers are “able to better understand the long-term financial implications of current and proposed policies, programs, and assumptions and decide on a course of action to achieve its goals.”⁶ Towards that end, NACSLB recommends that the proposed and operating budget serve as a comprehensive operating and financial plan. The format should be clear and comprehensible and should communicate key decisions, issues, and tradeoffs. In addition, the U.S. Government Accounting Office (GAO) recommends that financial information be useful, timely, relevant, and reliable.⁷

The GAO’s *Executive Guide: Creating Value Through World-Class Financial Management* advocates that organizations “[e]stablish an expectation that top financial executives, as part of the top management team, provide forward looking analysis that creates a link between accounting information and budget formulation and contributes to strategic planning and decision-making.”⁸ Having compiled a set of global best practices in budgeting, Arthur Andersen advises companies to link budget development to corporate strategy by setting goals before budgeting begins. “When this happens budget developers create from the start budgets that support strategic goals and that, therefore, need fewer revisions.”⁹

Mike Baxter of Marakon Associates, as quoted in Harvard Business School’s *Working Knowledge*, explains it this way:

⁶ National Advisory Council on State and Local Budgets, *Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting*, Government Finance Officers Association, 1998, p. 76. NACSLB was formed by the GFOA and included representatives from the public sector, private sector, academia, and labor. The guidelines can easily be applied to organizations outside government, and can serve as an important reference to budget officers in all industry sectors.

⁷ GAO/AIMD-00-134. *Executive Guide: Creating Value Through World-Class Financial Management*, April 2000, p. 29.

⁸ GAO, p. 15.

⁹ Arthur Andersen *Global Best Practices*, January 2000, as printed in *Inc.com* (<http://inc.com/articles/2000/01/16379.htm#Design>)

“When you’re clear on your strategic goals and have a process that integrates planning with resource allocation and performance management, budgeting can actually work... It becomes a mechanism for ensuring not only that funds flow first to the strongest opportunities, but also that those opportunities actually deliver on their promise.”¹⁰

Budget Process. NACSLB’s recommended budget process follows the same philosophy as that stated by Arthur Andersen and the Harvard Business School article: First, the organization should establish broad goals; second, develop approaches to achieve the goals; third, develop the budget; and then evaluate performance and make adjustments. This includes:

- ***Establish Broad Goals to Guide Decision Making***

Broad goals should provide overall direction and serve as a basis for decision making.¹¹ Because available resources often are limited, they should be “directed in a manner consistent with the concerns, needs, and priorities of stakeholders.”¹²

- ***Develop Approaches to Achieve Goals***¹³

Specific policies, plans, programs and management strategies should define how an organization will define its long-term goals.¹⁴ This includes adopting a policy on contingency planning to guide the financial actions government will take in the event of emergencies, natural disasters or other unexpected events. Examples of such emergencies include sudden and severe decreases in revenues or unexpected major capital maintenance requirements. “The policy should identify the types of emergencies or unexpected events and the way in which these situations will be handled from a financial management perspective.”¹⁵

- ***Develop the Budget***¹⁶

“A financial plan and budget that moves toward achievement of goals, within the constraints of available resources, should be prepared and adopted.”¹⁷

- **Prepare and Adopt a Budget.** Publish a comprehensive budget calendar that specifies when budget tasks are to be completed. Prepare general policy guidelines and budget preparation instructions for each budget cycle. Develop and use procedures for review, discussion, modification, and adoption of the proposed budget, in order

¹⁰ Loren Gary, *Working Knowledge*, Harvard Business School, August 11, 2003, p. 5.

¹¹ NACSLB, p. 5.

¹² NACSLB, p. 10.

¹³ The information for this section is taken from NACSLB, pp. 17-37 unless otherwise noted.

¹⁴ NACSLB, p. 5.

¹⁵ NACSLB, p. 26

¹⁶ The information for this section is taken from NACSLB, pp. 38-37 unless otherwise noted.

¹⁷ NACSLB, p. 5.

- to resolve conflicts, to promote acceptance of the budget by stakeholders, and to assist in timely adoption of the budget.
- **Evaluate Financial Options.** Conduct long-range financial planning to assess the long-term financial implications of current and proposed policies, programs, and assumptions and strategies to achieve the long-term goals.
 - **Project Revenues.** Prepare multi-year revenue projections; and maintain an in-depth understanding of major revenues. Evaluate the effect of changes to revenue rates and bases; and analyze fee exemptions. Achieve consensus on the revenue forecast.
 - **Prepare and Present a Budget.** “A complete plan is necessary to allow stakeholders to judge how well all of the different aspects of the plan fit together and whether there is an appropriate balance of resources and assigned uses.”¹⁸ The budget document should include: 1) a description of key programmatic and financial policies, plans, and goals; 2) highlights of key issues and decisions; 3) a description of the short-term and long-term financial plan; and 4) a guide to programs and operations including the organizational structure; 5) an explanation of the budgetary basis of accounting; 6) a clear presentation of financial, operating, and capital plans.
 - **Adopt a Budget.**
- **Evaluate Performance and Make Adjustments**
Program and financial performance should be evaluated, and adjustments made, to encourage progress toward achieving goals.
 - **Monitor, Measure and Evaluate Performance.** Periodic review helps an organization determine whether it is reaching its goals and making effective use of its resources. The organization “should evaluate its financial performance relative to the *adopted* budget... It is also an essential input in demonstrating accountability... Consistency and timeliness are particularly important when implementing this practice... In addition to monitoring budget-to-actual results, reasons for deviations should be evaluated. These factors are important in assessing the significance of variations, including whether they are expected to be temporary or longer-term in duration.”¹⁹ The organization should also monitor and evaluate its capital plan, financial condition, and external factors that may affect the organization’s budget, finances, and goals.
 - **Adjust the Budget.** The organization “should have procedures in place to determine when deviations from the budget plan merit adjustments to the budget... Final changes to the budget should be reported. The timing and manner in which this is done depends on the

¹⁸ NACSLB, p. 53.

¹⁹ NACSLB, p. 64.

stakeholder group and the level of materiality of the changes.”²⁰ The organization may also need to adjust policies, plans, programs, and management strategies, as well as goals during the budget period. If so, the adjustments should be based on the organization’s assessment of performance and new information about stakeholder needs and external circumstances.

Budget Revisions. As noted above, for the final phase of the budget process, NACSLB recommends evaluating performance and making adjustments as needed to complete the budget and planning cycle.²¹ When the budget needs to be adjusted in order for the entity to meet its goals, NACSLB recommends that “processes are needed to ensure that these adjustments are formally presented to decision makers and other stakeholders and receive adequate consideration.”²² It is important that there be in place procedures to determine when “deviations from the budget plan merit adjustments to the budget.”²³

Budgets should not be revised to cover up for poor performance or poor planning, and revisions should happen only if changing conditions truly warrant them.²⁴ In the event additional resources become available, action plans for using those resources be prioritized by *strategic* importance.²⁵

Background

Public Works found that, in many ways, EdFUND’s budget process and budget documents are generally aligned with the standards outlined above. For example, EdFUND’s system of top-down budgeting calls for strategic evaluation of non-core expenditures, and the Capital Utilization Plan provides CSAC and EdFUND with direction for allocating fund balances. Although EdFUND’s budget process generally meets acceptable budget principles, we identified a number of concerns with specific budget processes that reduce effective oversight, provide a disincentive for meaningful up-front planning, and create the appearance of inconsistent reporting. As discussed below, these findings fall within three general categories: budget process, other reporting issues, and operational efficiency.

Findings

Budget Process. Before identifying specific findings and recommendations regarding EdFUND’s budget process, it is helpful to understand the elements and timing of that process.

²⁰ NACSLB, p. 68.

²¹ NACSLB

²² NACSLB, p. 78.

²³ NACSLB, p. 68.

²⁴ *Arthur Andersen Global Best Practices*, January 2000, as printed in *Inc.com* (<http://inc.com/articles/2000/01/16379.htm#Design>)

²⁵ *Arthur Andersen Global Best Practices*.

In 2002, EdFUND began work on a “top-down” budget process and fully converted to it during the development of its fiscal year 2004-05 budget.²⁶ The “top-down” budget process arose from a recommendation by the Parthenon Group, a consulting firm hired by EdFUND to reform EdFUND’s budget process. According to the Parthenon Group, EdFUND’s “bottom up” budget process had two major weaknesses: 1) “Line-by-line accountability mentality does not stress finite size of the pie”; and 2) “Process does not force issue of whether line items should be there in the first place.”²⁷ The goal was to shift EdFUND managers to a cost-benefit mentality, where each expenditure is scrutinized to “ensure that valuable, finite resources are allocated optimally.”²⁸ It was labeled “top down” because rather than have managers build a budget line item by line item, the budget would be built from the “total expense dollars” set by the President and the Board.²⁹

In this “top-down” budget process, the total expense target is proposed by EdFUND’s President to the Board, and the Board in turn adopts the proposed target in February. Also in February, the Commission approves the expenditure target on recommendation from the Board of Directors after consultation with EdFUND staff.³⁰

In January, prior to adoption of the expense target by the Board and Commission, EdFUND staff members first develop a **core budget**.³¹ As stated in the EdFUND Overview of the 2003-04 Budget Proposal (June 2003):

“The top-down budgeting process implemented this year allowed managers to set expense goals at the beginning of the process. The goal set by senior management and the Finance, Budget & Audit Committee was to decrease loan program expenses, relative to the decreases in projected revenue, to ensure achieving an operating surplus in the loan program. This was accomplished through performing a detailed review of the 2002-03 budget and removing all items identified as non-recurring or discretionary.” (p. 1-2)

The December 15, 2003 EdFUND Financial Services Financial Forecasting Process Overview lays out the process as follows:³²

²⁶ As outlined in EdFUND’s December 15, 2003 Discussion Draft of ‘Loan Program Oversight: Capital Utilization December 2003,’ p. 1 of ‘Financial Forecasting Process Overview.’

²⁷ The Parthenon Group, “EdFUND Activity Optimization Project New Approach to Budgeting,” January 31, 2003, p. 2.

²⁸ The Parthenon Group, p. 3.

²⁹ The Parthenon Group, p. 2.

³⁰ Clarification provided by Mike Rothman, Chief Financial Officer, EdFUND, in telephone conference call March 4, 2005.

³¹ December 8, 2004 Interview with Margit Miller, Kelly Obrecht, Cindy Ridge, Trish Gentry, Denise Tebbs, and Diane Silva, Rancho Cordova, CA. Also, ‘EdFUND 2003-04 Budget Proposal, June 2003, page 1-2; and ‘EdFUND 2003-04 Core Budget (Divisional),’ ‘EdFUND 2003-04 Core Budget Detail of Proposed Adjustments,’

³² California Student Aid Commission, Loan Program Oversight, ‘Capital Utilization December 2003.’

Four in-depth forecasts are completed during the course of the fiscal year as targeted by key Financial Services Management and the Senior Financial Analyst. (p. 1 of 6)

This includes a preliminary setting of revenue and expense operating targets for top-down budgeting activities by January 21 (p. 1 of 6). While the EDFUND Financial Services Financial Forecasting Process Overview does not clarify who sets the preliminary revenue and expense operating targets, another document references Board and Commission adoption in February. During interviews with EDFUND staff, it was explained that EDFUND staff develop the preliminary revenue and expense operating targets in January.³³

The core budget starts with the best estimate of the current year's expenditures, and includes such items as payroll, building lease expenses, printing, postage, and professional fees. The core budget typically does not include one-time spending items, such as technology purchases, or anticipated discretionary spending. However, it may include **contingency items** from the prior year if those items resulted in ongoing costs. To give the EDFUND president discretion over a source of funds during the year for needs that could not be anticipated at the beginning of the fiscal year, EDFUND includes an explicit line item within its annual budget to meet organizational contingencies. The EDFUND **contingency budget** is equal to roughly 3 percent of the core budget.

The core budget is calculated in January before EDFUND staff members add discretionary project calculations to the budget.³⁴ The term **discretionary spending** is used to distinguish between core and **non-core expenditures** at this phase of the budget process. The annual EDFUND budget typically contains a number of one-time spending items and some discretionary spending, sometimes referred to as special projects. Once core expenditure levels are established, during the earliest phases of the budget process in January, discretionary items that meet the goals and standards as understood by EDFUND's President and senior staff are added to the core budget until an expenditure level is reached that meets an internally acceptable expenditure target. This process is explained in the EDFUND Overview of 2003-04 Budget Proposal (June 2003):

The top-down budgeting process called for an overall allocation of non-recurring funds to projects prioritized based on individual merits of initiative, cost benefit analysis, and other discussion. This resulted in the following list of prioritized projects and initiatives funded in addition to the core expenses mentioned earlier. (p. 1-2)

Proposed non-core expenditures are scrutinized by EDFUND's senior management for their contribution to achieving the performance goals established in

³³ December 8, 2004 Interview with Margit Miller, Kelly Obrecht, Cindy Ridge, Trish Gentry, Denise Tebbs, and Diane Silva, Rancho Cordova, CA.

³⁴ December 8, 2004 Interview with Margit Miller, Kelly Obrecht, Cindy Ridge, Trish Gentry, Denise Tebbs, and Diane Silva, Rancho Cordova, CA.

EDFUND's Operating Dashboard. In addition, these non-core expenditures (also referred to as discretionary items) undergo a cost-benefit analysis to evaluate their relative merit.³⁵ High-priority projects receive non-recurring funds, which are added to EDFUND's core expenses.³⁶ This process of allocating non-core expenditures is referred to as the "top-down" budget.

In the 2003-04 budget cycle, EDFUND's senior management and the Finance, Budget & Audit Committee set the broader goal of decreasing loan expenses relative to projected revenue to achieve an operating surplus in the loan program.³⁷ EDFUND sets preliminary revenue and expense operating targets for "top-down" budgeting activities, including expenditure targets for each division. EDFUND then creates a long-range forecast of revenues and expenditures at a very high level of detail for the current year plus five additional years, to accompany their presentation of their recommendation for the annual budget's expenditure targets and revenue forecast to the Board and Commission

Once this is all completed, the resulting annual total expenditure target and revenue estimate along with the five-year forecasts are presented to the Board and Commission in February for approval. The Commission approves the amount of total spending against the backdrop of EDFUND's revenue estimate. According to the goals of the joint financial planning framework for EDFUND and CSAC, the two organizations will work towards maintaining a reserve of \$100 million, or the amount needed to fund one full year of operating costs for both CSAC and EDFUND.³⁸ The specific goal of maintaining a \$100 million reserve was not expressed in the documentation of the joint proposal to the CSAC Fiscal Policy and Long Range Planning Committee and Finance, Budget and Audit Committee of the EDFUND Board. The proposal was adopted by both committees in November 2003.³⁹ The joint staff report discussed uses of the \$275 million fund balance. (See discussion below regarding the Capital Utilization Plan.) This discussion occurred prior to the State requiring \$146.5 million of the balance be used to support the Cal Grants program.

While the expenditure targets are set with only four months expenditure experience from the current fiscal year, the expenditure target is not revisited for the remainder of the budget process.

In April, EDFUND's Finance Division conducts a mid-year review of EDFUND's performance, and recalculates the revenue forecast if necessary. Revenues are formally forecast and re-forecast quarterly, but in practice are forecast monthly for the duration of the budget process. The Board and Commission receive these updated revenue forecasts on a monthly basis for informational purposes. In July, EDFUND staff

³⁵ January 31, 2003, presentation by Michael Rothman to the Finance, Budget & Audit Committee, "Activity Optimization Project – New Approach to Budgeting."

³⁶ "EDFUND 2003-04 Budget Proposal, June 2003."

³⁷ EDFUND 2003-04 Budget Proposal, June 2003, 'EDFUND Overview of 2003-04 Budget Proposal,' p. 1-2.

³⁸ Paper titled "Financial Planning Team Report", prepared October 15, 2003 by Michael Rothman.

³⁹ Joint Staff Report and Recommendations, November 19, 2003.

adjusts the operating and federal fund revenue forecasts that will be used for the next budget, and in August, EDFUND re-forecasts the current year's expenditures and revenues at a high level to refine their estimate of the current year's final surplus. These adjustments are not subject to Board approval but are provided to the Board as information items. The forecasts help inform the discussion of the budget. Final current year forecasts, along with the five-year forecasts based on the expenditure target adopted in February, are published in the Business Plan and presented to the Board and Commission.

The EDFUND Board then approves a detailed budget, thus creating the "approved" budget. In September, the final forecast for the year is calculated, ensuring that the year-end forecast ties closely to actual revenues and expenses and captures any changes in assumptions that might have an impact on the top-down budgeting; EDFUND staff then recalculates the current fiscal year forecast of the surplus based on the expenditure target and detailed budget adopted by the Board. This is done in November using final financial figures from the previous fiscal year ending September 30

As a part of this process, EDFUND uses a financial planning tool called the **Capital Utilization Plan (CUP)**. Once the fiscal year ends and the final difference between revenues and expenditures is calculated, the CUP provides a framework for EDFUND and CSAC to allocate or designate uses for the remaining reserves. The purpose of the CUP is "to provide a basis for understanding the future revenues available for operations and the likely levels of expenditure necessary to meet the Organization's objectives over a five-year time horizon."⁴⁰ In other words, the CUP allocates the existing fund balance across programs. The CUP is less a budgeting tool than an explanation of how undesignated fund balances will be designated. In the event that fund balances grow or shrink, the CUP provides a mechanism for EDFUND and CSAC to address how those changes in reserves should be allocated across programs or operations. CSAC and EDFUND senior staff recommended to the Board and Commission that the Capital Utilization Plan and allocation methodology need not be revisited until 2008 or 2009 following the reauthorization of the Higher Education Act.⁴¹ However, the plan is to be updated and presented to the Board and Commission annually.⁴²

EDFUND should be commended for its adoption of the new "top-down" budgeting method. This budgeting process provides the opportunity for a strategic approach to evaluating expenses for their overall contribution to EDFUND's mission as well as their cost-effectiveness, rather than fragmenting budget decisions by division or line item and spending funds until a cap has been reached.

⁴⁰ Joint Staff Report and Recommendations, Fiscal Policy and Long Range Planning Committee, CSAC, and Finance, Budget and Audit Committee, EDFUND Board of Directors, November 19, 2003, p. 5 of 7.

⁴¹ Joint Staff Report and Recommendations, Fiscal Policy and Long Range Planning Committee, CSAC, and Finance, Budget and Audit Committee, EDFUND Board of Directors, November 19, 2003, p. 4 of 7..

⁴² "Financial Planning Team Report," created Oct. 15, 2003, sent via e-mail from EDFUND March 4, 2005.

However, the EdFUND budget process does raise some concerns. The following sections outline these concerns and offer recommendations to assist EdFUND in strengthening its budget process and budget documents:

The Difference Between the Approved Budget and the Actual Expenditures for EdFUND's Budget Has Averaged 10.3 Percent over the Last Three Years. On average, EdFUND's actual spending levels have been 10 percent less than the spending targets approved by the EdFUND Board and the Commission in fiscal years 2001-02, 2002-03 and 2003-04. In dollar terms, actual expenditures ranged from \$8.3 million to \$11.4 million less than the approved budget for each of the last three fiscal years. (See Table 1.) The cause for the adjustment is due to a large degree to changing revenue levels. To maintain the amount of the surplus (i.e., difference between revenues and expenditures) as stated in the budget adopted by the Board and Commission, a decline in revenues requires a commensurate reduction in expenditures. Due to efforts at achieving efficiencies through more effective use of technology and staff, EdFUND was able to keep expenditures at a level 10 percent below the approved budget and preserve the surplus. EdFUND operated below the approved spending level each year without adversely affecting operations, pay raises, or bonuses. EdFUND has demonstrated a consistent ability to effectively maintain operations at an expenditure level averaging about \$85 million per year.

It is prudent to maintain some slack in the budget. Nevertheless, an approved budget that consistently includes a 10 percent variance brings into question the ongoing accuracy of expenditure targets. EdFUND consistently manages to operate effectively at expenditure levels below \$87 million, yet for each of the last year, it has built a core budget and non-core budget that results in an expenditure target of more than \$91 million. EdFUND had the option of presenting the Board and Commission with a lower expenditure target by limiting the non-core expenditures added to the core budget, and thus increasing the size of the loan program surplus goal each year. An approved budget with expenditure targets consistently 10 percent above actual expenditures indicates that EdFUND may be missing an opportunity to drive towards the greatest possible surplus each year.

An analysis of the expenditures for each of the three years cited shows that 48 to 92 percent of the variance between the approved budget and actual expenditures can be accounted for in four objects of expense: Contingency (5801), Consulting fees (5202), Computer Consulting Fees (5201) and Program Grants & Awards (5660). These items combined came in below the approved budget by \$8.8 million in 2001-02, \$7.7 million in 2002-03, and \$4.0 million in 2003-04.⁴³

⁴³ Oracle printouts as follows: EdFUND Budget Year 2001/02, Monthly to Actual Report, Date printed 10/23/2002 08:57 AM, annotated 'EdFUND w/o DPI or VFA', pp. 3, 5; EdFUND Budget Year 2002/03 Monthly Budget to Actual Report, Date printed 10/14/2003 12:50 PM, annotated 'EdFUND Rollup w/o Non-Loan Program, pp. 3, 5 ; EdFUND Budget Year 2003/04 Monthly Budget to Actual Report Date Printed 10/19/2004 08:51 AM, annotated 'EdFUND all loan program', pp. 3,5.

A significant portion of the budget variance each year appears to be absorbed by not just by four spending categories, but, more specifically, in one program. Nearly all of Program Grants & Awards was budgeted under External Relations in 2001-02 and 2002-03, and under EDSHARE in 2003-04. An analysis of the budget variance shows that more than 40 percent of EdFUND's total budget variance each year can be accounted for in the budget variance for External Relations (2001-02 & 2002-03) or EDSHARE (2003-04), and Contingency (see Table 1). An analysis of budget variance over the last three years indicates that EdFUND may have over-allocated resources in Program Grants & Awards as it builds its proposed expense target (built from core and non-core expenditures). Each year, actual expenditure levels for the External Relations and EDSHARE programs have been below the approved budget by an amount ranging from \$1 million to \$5.4 million -- the difference between what is budgeted and what is spent ranges from \$1 million to \$5.4 million.

Table 1. Analysis of Variance to Actual, EdFUND Loan Program.⁴⁴

	2001-02	2002-03	2003-04
Approved Budget	\$95,017,452	\$98,214,128	\$91,122,255
Actual YTD	\$85,435,089	\$86,820,152	\$82,847,865
<Over>/Under Budget	\$ 9,582,363	\$11,393,976	\$8,274,390
Variance of Approved to Actual	10.1%	11.6%	9.1%
EdFUND External Relations Variance	\$ 3,288,452	\$5,421,894	
EDSHARE Variance			\$1,073,848
Contingency Variance	\$843,741	\$1,632,770	\$2,282,063
Variance Subtotal	\$4,132,193	\$7,054,664	\$3,355,911
Percent of Total Variance	46.8%	61.9%	40.6%

Note: The figures include both EdFUND and CSAC operations. The figures do not include VFA or restricted expenses. They also do not include the Cal-SOAP program.

A consistent 10 percent budget cushion does not encourage aggressive revenue maximization or cost containment strategies throughout the year, as the organization could operate inefficiently and easily still meet budget projections. Our concern

⁴⁴ Oracle printouts as follows: EdFUND Budget Year 2001/02, Monthly to Actual Report, Date printed 10/23/2002 08:57 AM, annotated 'EdFUND w/o DPI or VFA', page 5 of 5; EdFUND Budget Year 2002/03 Monthly Budget to Actual Report, Date printed 10/14/2003 12:50 PM, annotated 'EdFUND Rollup w/o Non-Loan Program, page 5 of 5; EdFUND Budget Year 2003/04 Monthly Budget to Actual Report Date Printed 10/19/2004 08:51 AM, annotated 'EdFUND all loan program', page 6 of 6.

regarding an approved budget that consistently is set millions of dollars above actual spending levels is not with the level of spending, but with the level of the approved budget.

EDFUND Could Provide Greater Clarity Regarding What the Desired Annual Surplus and Resulting Expenditure Target Is in Light of Longer-Term Goals for Operating Reserves. EDFUND's process for establishing expenditure levels for the upcoming year is driven in part by the calculation of the surplus of revenues over expenditures, characterized as the "gold standard" for the budget by EDFUND's budget staff.⁴⁵ One of EDFUND's key financial metrics is the Loan Program Operating Surplus Margin, which is directly dependent on the surplus. Because EDFUND is not subject to the same budget constraints as a State agency, namely the "use it or lose it" rule, it has the option of ending each year with a surplus. The accumulated surpluses can then be strategically targeted as EDFUND's Board and the Commission deem appropriate. Being freed from the "use it or lose it" constraint allows EDFUND to create and execute long-range strategies, which will could ultimately lead to more affordable financial aid to the State's students.

The size of the projected and actual surplus varies each year. The challenge EDFUND faces is setting expenditure targets that allow for strategic accumulation of reserves. The Financial Planning Team Report states, "The Organization [EDFUND and CSAC] will carry a 'Reserve for Operations' to provide resources in case of unexpected events. This reserve will be funded at \$100,000,000 or approximately equal to one full year of operating costs for CSAC and EDFUND." According to the EDFUND Loan Program Business Plan 2004-05 (September 30, 2004), ending net assets for 2004-05 are projected to be \$165.3 million. The document that mentioned the \$100 million reserve did not include an explanation as to why a twelve-month operating expense reserve for CSAC and EDFUND combined was chosen as the target to be presented to and adopted by the Board and Commission.⁴⁶ The Commission minutes that document adoption of the CUP make no mention of the \$100 million reserve as a goal. The five-year forecast presented in the 2004-05 Budget and Planning document shows declining annual surpluses for the Loan Operating Program for three of the next five years.

⁴⁵ December 8, 2004. Interview with Margit Miller, Manager, Finance Reporting and Analysis Unit, along with Kelly Obrecht, Associate Budget Analyst, Cindy Ridge, Budget Analyst, Trish Gentry, Financial Report Analyst, Denise Tebbs, Financial Report Analyst, and Diane Silva, Sr. Financial Analyst, EDFUND, Rancho Cordova, CA.

⁴⁶ California Student Aid Commission, Commission Meeting, Minutes, November 21, 2003, pp. 5-6. Also, "Financial Planning Team Report," as provided by Michael Rothman, document creation date of October 15, 2003.

Table 2. Five Year Forecast of EdFUND/CSAC Operating Fund Surpluses, Loan Program (dollars in millions).

	2003-04 Forecast	2004-05 Forecast	2005-06 Forecast	2006-07 Forecast	2007-08 Forecast	2008-09 Forecast
Total Revenues	94.6	99.7	92.6	93.8	103.3	113.1
Total Expenses	79.1	87.2	85.4	93.0	95.9	99.3
Operating Surplus	15.5	12.5	7.2	0.8	7.3	13.9

In fiscal year 2003-04, \$146.5 million of EdFUND's accumulated surplus of over \$275 million was taken by the State to fund the Cal Grant program. By committing future surpluses and creating a coordinated strategy to preserve a specified level of reserves, EdFUND and CSAC may be working to secure some degree of long-term stability in a State faced with significant budget deficits.

With regards to the desired level of reserves, EdFUND's Business Plan provides no discussion of quantified strategic goals that drove the setting of expenditure targets. The only mention of the strategy underlying expenditure targets and the resulting loan program surplus in the FY 2004-05 Business Plan is, "As we did last year we set expense targets early in the process to help ensure that desired standard operating surplus results are achieved."⁴⁷ However, no mention is made of what the desired surplus is or what makes it "desirable." EdFUND financial executives explained that the goal is to "optimize the bottom line surplus and larger goals for the mission of the organization."⁴⁸ Given that those goals – especially the larger, longer-term goals -- remain fairly consistent for the organization, a more concrete explanation would be beneficial. For example, "optimize bottom line surplus" could mean to hold expenditure growth within 5 percent of the prior year. "Optimize the larger goals for the mission of the organization" could mean to work towards a fund balance or reserve of \$150 million over a five-year period to achieve strategic changes (new staff, new systems, new marketing activities), driving the goal of each year's surplus to average \$30 million.

As mentioned previously, the Financial Planning Team Report states that there be a "Reserve for Operations" of \$100 million. However, there is no explanation of how the 2004-05 expenditure targets in relation to forecasted revenues will contribute to the reserve goal. The Capital Utilization Plan provides direction regarding how to manage the estimated surpluses, but this is *after* decisions have been made that will determine the size of the surplus available for managing.

⁴⁷ "The Loan Program 2004-05 Budget Proposal," p. 5, as presented in "Loan Program Business Plan 2004-05, Prepared for the Board of Directors of EdFUND and the California Student Aid Commission, September 30, 2004."

⁴⁸ January 7, 2005, Telephone interview with Michael Rothman, Chief Financial Officer.

Once Aggregate Spending Targets Are Established, the Commission Has No Further Involvement in How EdFUND Allocates Expenses. The core budget plus discretionary spending proposed by EdFUND staff and adopted by the Board and Commission determine the expenditure target for the upcoming fiscal year. The proposed expenditure target is based on EdFUND staff discussion regarding changing circumstances, both internally and externally, as well as strategic projects and strategic goals. The discussions are part of EdFUND's aforementioned "top-down" budgeting process.⁴⁹ During the transition to top-down budgeting, \$2.973 million was included in the 2004-05 proposed budget as "Project funding to be allocated." This figure is in addition to \$2.3 million in contingency.⁵⁰ According to the minutes of the November 21, 2003 Commission meeting, the Commission approved the proposed process whereby, "the Commission will approve the detailed Operating Budget of CSAC and the outreach campaign; the EdFUND Board will approve the detailed budget of EdFUND for the operation of the FFEL Program."⁵¹ The wording that was adopted by the Commission was slightly but significantly different from the Financial Planning Team Report (document preparation date of October 13, 2005), which proposed, "The EdFUND Board would approve the detailed budget for EdFUND activities without the need for further review by the Commission."⁵²

Thus, the Commission appears to have no formal role with regards to the amount of funding EdFUND chooses to allocate to contingency, discretionary, and core expenses. The Commission also appears to have no formal role with regards to how EdFUND prioritizes resource allocation across major program areas.

In its oversight role, it is not necessary for the Commission to micromanage EdFUND's budget. Having approval authority with regards to programmatic allocation of resources, however, is not micromanaging. Since both EdFUND and CSAC must finance their operations from the Loan Operating Fund, the Commission has a stake in the decisions EdFUND makes with regards to the strategic use of its resources, and whether or not those uses create ongoing expenses. As stated in the first part of this chapter, budgets serve as an essential tool for managing an organization, both fiscally and strategically, for the short-term and the long-term. The budget expresses an operational plan in financial terms. The Commission has a direct stake in EdFUND's fiscal and strategic performance and therefore should have a commensurate role in approving EdFUND's budget.

The Contingency Budget Provides Unnecessary Budget Flexibility and Reduces Budget Accountability. An explicit line item – called the contingency budget – is built into EdFUND's annual budget to provide the EdFUND president with discretionary spending flexibility to meet needs that could not be anticipated at the

⁴⁹ "EdFUND Business Plan 2003-04, Prepared for the Board of Directors of EdFUND and the California Student Aid Commission," August 22, 2003, p. 5.

⁵⁰ EdFUND Loan Program Business Plan 2004-05, Prepared for the Board of Directors of EdFUND and the California Student Aid Commission, September 30, 2004, 2004-05 Budget Proposal, p. 2.

⁵¹ California Student Aid Commission, Commission Meeting, Minutes, November 21, 2003, p. 6.

⁵² Page 4 of 4.

beginning of the fiscal year. The EDFUND contingency budget equals roughly 3 percent of the core budget -- \$2.3 million in FY 2004-05.

The contingency budget item was added to EDFUND's budget beginning in FY 2000-2001. The approach to EDFUND's contingency item was to give the President discretion over a source of funds during the year for needs that could not be anticipated at the beginning of the fiscal year. The contingency budget was established by EDFUND staff and accepted by the Board through its approval of EDFUND's budget, at 3 percent of the core budget as the result of an analysis performed four years ago of unofficial contingency levels.⁵³ Amounts of implicit contingency spending were pulled from other lines in the budget and aggregated into an explicit item labeled contingency budget.

The contingency item is added to the budget by EDFUND staff and is part of the budget presented to the Board and Commission for final approval, after discretionary items are built back into the core budget.

The following concerns arise from EDFUND's use of its contingency funds:

- EDFUND appears to have enough flexibility in its budget already to warrant the elimination of the 3-percent contingency line item.
 - EDFUND's actual expenditures consistently fall well below budget estimates, especially budgeted expenditures for consulting and programs & grants awards.
 - EDFUND's actual expenditures of the contingency funds also consistently fall well below the estimated contingency budget.
 - Despite consistent under-spending of the contingency budget, EDFUND recently asked for a 25 percent *increase* in its contingency line item.
 - The 3 percent contingency funding level was prior to the adoption of top-down budgeting and has not been revisited in four years.
- EDFUND sometimes does not follow its own guidelines governing the use of contingency funds.
- No Board or Commission prior approval is required for the use of contingency funds.
- It is difficult for EDFUND overseers to follow how the contingency funds are used based on the current reporting methods in place.
- The current process of spending funds from the contingency line leads to changes to approved budget figures.

⁵³ Interview with Michael Rothman, Chief Financial Officer, EDFUND, December 9, 2004, Rancho Cordova, CA.

- The inclusion of the contingency item within the calculation of the Loan Surplus Margin makes this key organizational metric less precise and meaningful as a performance assessment tool.
- The presence of a 3 percent buffer in the budget may allow for less disciplined up-front planning for expenditures.

These issues are described in detail below:

- **EdFUND appears to have considerable flexibility in its budget already.** The justification for the contingency is to meet unanticipated expenses and build flexibility to meet those expenses into the budget. However, each year since the 3 percent contingency has been in place, EdFUND's actual expenditures have come in under budget by substantially more than 3 percent (see Table 3). Flexibility already appears to be built into EdFUND's budget for consulting fees, computer consulting fees, and program grants & awards. The variance for these three items alone equaled 9 percent of the approved budget without the contingency in 2001-02. In subsequent years, the variance accounted for 6 percent and 2 percent. In other words, each year the unspent amount for these three items exceeded the amount *spent* on contingency items. In dollar terms, the total *actual* budget ranged from \$8.3 million to \$11.4 million *less* than the approved budget for each of the last three fiscal years (see Table 4). The adjustments to expenditures through the course of the fiscal year are due largely to changing revenue levels. However, an analysis of budget data indicates that EdFUND's approved budget could have been reduced by \$8-\$11 million without adversely affecting operations and still allowing for pay raises and bonuses.

Table 3. Analysis of Variance of Objects 5660, 5202, and 5201.

		2001-02			2002-03			2003-04		
		Approved Budget	Actual YTD	<Over>/Under Budget	Approved Budget	Actual YTD	<Over>/Under Budget	Approved Budget	Actual YTD	<Over>/Under Budget
5660	Prog. Grants & Awards Consulting	\$4,000,000	\$ 1,430,520	\$ 2,569,480	\$4,493,900	\$3,104,858	\$1,389,042	\$4,001,500	\$2,924,811	\$ 1,076,689
5202	Fees	\$6,704,745	\$ 2,345,127	\$ 4,359,618	\$2,975,040	\$1,827,974	\$1,147,066	\$2,090,613	\$1,706,158	\$ 384,455
5201	Computer Consulting Fees	\$2,499,740	\$ 1,445,011	\$ 1,054,729	\$5,120,837	\$1,583,343	\$3,537,494	\$1,073,493	\$ 848,110	\$ 225,383
	TOTAL			\$ 7,983,827			\$6,073,602			\$ 1,910,225
	% of total Approved Budget (less Contingency)			9%			6%			

Table 4. Variance of Approved to Actual Budget Levels, EdFUND Loan Program, with Contingency Budget Noted.

	2001-02	2002-03	2003-04
Approved Budget	\$95,017,452	\$98,214,128	\$91,122,255
Actual YTD	\$85,435,089	\$86,820,152	\$82,847,865
<Over>/Under Budget	\$ 9,582,363	\$11,393,976	\$8,274,390
Variance of Approved to Actual	10.1%	11.6%	9.1%
<i>Contingency Budget*</i>	\$ 2,492,850	\$2,691,200	\$ 3,116,063

*As reported in "EdFUND Contingency Fund Budget and Uses" document for each year.

Note: The figures include both EdFUND and CSAC operations. The figures do not include VFA or restricted expenses. They also do not include the Cal-SOAP program.

An analysis of how much was budgeted versus how much was spent specifically in the contingency budget reinforces this point. Contingency budget expenditures have not exceeded \$2 million in the last four years; however, the contingency line item continues to be budgeted at more than \$2.3 million each year. (See Table 5.)

Table 5. Contingency Fund Analysis.

Contingency Fund	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
Budgeted	2,954,832	2,492,850	2,691,200	3,116,063	2,313,000
Spent	(\$2,335,174)	(\$1,649,109)	(\$1,058,430)	(\$834,000)	N/A
Annual Balance	\$619,658	\$843,741	\$1,632,770	\$2,282,063	N/A
Unspent Percent of Contingency	21%	34%	61%	73%	

In FY 2003-04, EdFUND requested a 25 percent increase in the contingency budget *beyond* the 3 percent of expenses.⁵⁴ The explanation for this increase was that the change to top-down budgeting meant that EdFUND would need even greater flexibility built into its budget than in prior years. As noted earlier, the contingency fund was added to EdFUND's budget beginning in FY

⁵⁴ EdFUND Business Plan 2003-04, Prepared for the Board of Directors of EdFUND and the California Student Aid Commission, August 22, 2003, 'Budget Proposal,' p. 12.

2000-01, prior to the institution of top-down budgeting, whereby amounts of implicit contingency spending were pulled from other lines in the budget and aggregated into an explicit item labeled contingency budget. Despite the creation of the contingency budget to eliminate decentralized contingency spending in the departments, the request for a 25 percent increase is evidence that the embedded contingency funding continued into 2003 *along with* the explicit 3 percent contingency budget line. Therefore, the elimination of the departmental contingency spending with the top-down budget process required that the contingency budget line be increased by 25 percent to preserve some portion of the departmental contingency spending on top of the 3 percent contingency budget.

The new top-down budgeting process was intended to be much more strategic, with non-core spending items added to the budget after defining core expenditures. Given this, there should be *less* of a need for unallocated, discretionary budget authority with the new process, not more.

Changing the budgeting system should have strengthened the organization's ability to align resources with strategy. Given the data above, it is not clear why EDFUND's improved budgeting system would require a greater percentage of resources to remain outside of that alignment, as doing so introduces additional uncertainty regarding the resources available to division heads for implementing their plans, if not fewer resources than otherwise would have been available.

At present, EDFUND has no plans to revisit the 3 percent amount for the contingency budget.⁵⁵

- **EDFUND sometimes does not follow its own guidelines governing the use of contingency funds.** According to the description in EDFUND's FY 2003-04 Business Plan, the contingency budget is to be used for "expenses that are unanticipated or unforeseen during the budget preparation process."⁵⁶ EDFUND has developed written guidelines that govern the use of the budgeted contingency funds.

The written contingency budget guidelines are not part of EDFUND's formal organizational policies. EDFUND clarified this point when they corrected an information request submitted by Market Value

⁵⁵ December 9, 2004, Interview with Michael Rothman, EDFUND Chief Financial Officer, Rancho Cordova, CA.

⁵⁶ December 8, 2004, Interview with Margit Miller and her staff, EDFUND, Rancho Cordova, CA.

Planners (MVP) for the justification for the contingency expenses. MVP referred to policy, and EDFUND was careful to strike through “policy” and replace it with “guidelines.”⁵⁷ EDFUND further clarified that these were informal guidelines:

“These guidelines were written internally by EDFUND to provide managers advice about information which the President or CFO may not already have; however, the bulleted items listed in the request have not been required in writing by the President and CFO when the information is already known by them.”⁵⁸

Some of the uses of the contingency budget during the last three years have included an upgrade of EDFUND’s conference rooms (FY 2002-03), project consultants for system enhancements and optimization (FY 2003-04), marketing and business consulting for a \$400,000 contract approved two months prior to the end of the fiscal year (FY 2003-04), and hiring 9 staff for systems development teams (FY 2001-02).⁵⁹ The limited time for this review did not allow us the opportunity to review in greater detail the reasons why each of these projects was not a part of the current year’s budget process or could not be postponed to the subsequent budget year. At initial glance, these projects do not appear to be the type of project that would be completely unanticipated during the budget planning phase, or could not be part of the regular budget process for the following year.

- **There is no Board approval of the specific use of contingency funds prior to contingency funds being spent.** After the beginning of the fiscal year, a Vice President who requests to use contingency budget funds submits a proposal to the CFO, who then takes the request to the President for review. The President makes the final determination, sometimes in consultation with the Executive Management Team.⁶⁰ The use of contingency funds is reported to the appropriate committees, but its use is not subject to prior approval by the EDFUND Board, or the Commission, unless it falls within the requirements that other expenditures are subject to

⁵⁷ Memorandum dated December 22, 2004, to Kathleen Stanley, CSAC, from Janie Holland, EDFUND, Subject of Follow-Up Request for Information Dated December 15, 2004, Item No. 7, page 3.

⁵⁸ December 22, 2004 Memorandum, p. 4.

⁵⁹ “EDFUND Contingency Fund Budget and Uses for 2001-02”, EDFUND Contingency Fund Budget and Uses for FY 2002-03,” EDFUND Contingency Fund Budget and Uses for 2003-04” as provided in response to Memorandum, dated November 24, 2004, from Mark Grisby, Chief Federal Policy & Programs Division, CSAC, to Wendie Doyle and Michael Rothman, EDFUND.

⁶⁰ Document titled, “Contingency Fund Guidelines and report on usage of funds.”

with regards to approval, such as a contract for more than \$100,000.

In the absence of the contingency budget, the President would need to request budget amendments at the quarterly Board meetings to address urgent, unfunded expenses that required significant changes to categories in the approved budget or that required an augmentation of bottom-line expenditures. In reviewing EdFUND's contingency budget uses, it does not appear that such an augmentation could not have waited for a quarterly Board meeting or subsequent approval by the Commission. Given the Board's active participation and approval of quarterly re-forecasting of revenues, it would seem a natural fit to require the Board to consider and approve these expenditure issues as well.

Similarly, there would not be a significant lapse of time needed for EdFund to get expenditure approvals from both the Board of Directors and the Commission. Table 6 lists the 2004 meeting dates of the EdFUND Board of Directors and of the California Student Aid Commission:

Table 6. 2004 Meeting Dates of the EdFund Board of Directors and California Student Aid Commission

Month	EdFUND Board of Directors Meeting Date	Commission Meeting Date	No. of Business Days from Board meeting to next CSAC meeting
February	20 th	4 th -5 th	
March		8 th	11 days
April	20 th	22 nd	2 days
May	14 th , 17 th	17 th	3 days/same day
June		24 th	
July	22 nd -23 rd	22 nd -23 rd	Same day
August	20 th	9 th , 25 th	3 days
September		9 th -10 th	
October			
November	8 th	9 th	1 day
December	10 th		

As Table 6 illustrates, the greatest length of time between an EdFUND Board of Directors meeting and a CSAC meeting in 2004 was 11 business days. In all but one case, the delay would have been three days or less.

- **It is difficult to track the use of the contingency fund in the Monthly Budget Variance report.** As funds are spent out of the contingency budget (object of expense 5801, under “General Expenses”), the contingency line is decreased and other line items are increased. As a result, each monthly budget report comparing budgeted expenditures to actual expenditures will always show \$0 for contingency actual YTD expenditures, while the amount for the approved budget for contingency will change as the contingency line item is reduced for expenditures. The contingency item amount should not necessarily be taken at face value as reported in the monthly budget reports. Instead, the reader would need to know what the original approved amount was for contingency at the beginning of the fiscal year, then subtract from the original approved amount the figure reported as “approved” in the monthly report they are reading. The difference between the original approved amount and the amount reported in the monthly report will be the actual amount spent year to date out of the contingency line.

As contingency funds are spent, other line items in the “Approved Budget” column are increased according to the type of expenditure. While this preserves the bottom line approved budget total, it results in a change to approved budget figures. For example, the 2003-04 budget as presented in the EDFUND Business Plan 2003-04 shows the contingency budget at \$3.116 million. The document titled “EDFUND Contingency Fund Budget and Uses For 2003-04”, footnoted as being printed 12/2/2004, also shows the ‘Original Contingency Budget’ at \$3.116 million. But the Monthly Budget to Actual Report printed 10/19/2004 shows the Approved Budget figure for Contingency to be *\$2.282 million*. That means that other items in the Approved Budget would have been changed by a total amount of \$834,000 to preserve the Approved Budget bottom line.

- **The inclusion of the contingency item within the calculation of the Loan Surplus Margin makes this key organizational metric less precise and meaningful as a performance assessment tool.** As mentioned above, the Loan Program Operating Surplus target is one of EDFUND’s top-level financial metrics, helping the organization and its overseers to assess how well EDFUND is progressing towards its state financial performance goal of achieving and maintaining “one of the highest operating margins in the guarantee industry by the end of 2007-08.”⁶¹ The Loan Program Operating Surplus Margin includes the 3 percent contingency in expenses. The inclusion of the contingency budget in the Loan Program Operating Surplus potentially is problematic. The inclusion of the contingency fund within the calculation of the Loan

⁶¹ EDFUND Loan Program Business Plan 2004-05, Prepared for the Board of Directors of EDFUND and the California Student Aid Commission, September 30, 2004, Organizational Overview, p. 7.

Program Operating Surplus could enable EdFUND to improve its performance substantially towards the achieving surplus target simply by not spending the contingency.

For example, the Loan Margin target for FY 2004-05 is 12.5 percent. This is based on a surplus of \$12.5 million remaining after expenditures of \$87.2 million against revenues of \$99.7 million. If the contingency budget of \$2.3 million remains unspent, the actual target performance would total \$14.8 million or 14.8 percent. These 2.3 percentage points (\$2.3 million) tied to the contingency budget represent nearly 20 percent of the original target of 12.5 percent. Another way of looking at this problem is from the revenue side. Without making any other adjustments in expenditures other than not spending the contingency fund, revenues could decline by \$2.3 million without affecting the target margin.

By removing the contingency budget from the calculation of the expenditure variable used to calculate the Loan Program Operating Surplus target metric (revenues minus expenditures), EdFUND has the opportunity to make this critical metric even more robust. For example, if the Surplus target is \$12 million, which includes a \$3 million contingency in the loan program expenses, then the target should be set at \$15 million (the difference between *\$84.2 million* instead of *\$87.2 million* in expenditures and \$99.7 million in revenues). This establishes a disincentive for using the contingency budget but still makes the contingency available within the budget authority granted to EdFUND, should it be needed.

Changes in EdFUND's Approved Budget Figures Are Challenging to Track. Once a budget is approved, the approved amounts should remain unchanged in each monthly budget report unless a formal, documented request to change the approved figures has been affirmed by the Board and Commission. This is especially important for any public or quasi-public entity that handles public dollars or is subject to public scrutiny. This policy applies to not only the bottom line, but to the internal allocation of funds by division as well as by major expenditure categories. The approved budget is EdFUND's statement of a plan. Measuring EdFUND's performance against that plan, and ultimately, the quality of the plan itself, becomes more difficult if the approved budget numbers change during the fiscal year. As discussed above, because of the way the contingency budget is implemented, each time an expenditure is made out of the contingency line, other lines in the approved budget must be adjusted, including the contingency line.

CSAC staff face the challenge of having to request special documentation and carefully track the approved budget figures, in order to ascertain how EdFUND has changed its approved budget.⁶² While documentation is ultimately available to identify

⁶² Telephone interview with Antonio Perez, former Associate Accounting Analyst, CSAC, January 10, 2005.

changes, no regular report explicitly retraces EdFUND's expenditures from the original approved figures to the revised approved figures. "Revised approved figures" means the approved budget adopted by the Board and Commission that is subsequently changed through formal action of the Board or Commission or through adjustments in line items as a result of expenditures from the contingency line. The report we recommend, which could be a roll-up of all departments but detailed by object of expense, would include a column of the original approved budget figures, a column with the modified/amended approved budget figures, and a column showing the difference. The report would be accompanied by narrative explaining the differences.

EdFUND does produce quarterly financial statements for its Board of Directors but these fall short of what would be most useful. For example, for the first two quarters of 2003-04, EdFUND produced documents with the headings cited above, which detailed EdFUND's budget by natural category (Salaries & benefits, Computer expenses etc.) Because of the way the contingency budget is implemented, each time an expenditure is made out of the contingency line, other lines in the approved budget must be adjusted, including the contingency line. However, the contingency line item is not included in the detail of these reports.

The format for the first two quarters was as follows:

	2002-03 Actuals	2003-04 Budget	2003-04 Forecast	2003-04 Budget vs. 2003-04 Forecast
Revenues FFEL Prog.				
Expenses				
CSAC				
EdFund				
Other Initiatives				

This compares to the last two quarters of the same fiscal year, where the financial statement was organized as follows:

	Prior YTD	Current YTD	Variance	Annual Budget	Annual Forecast	Variance
Standard Activity						
Revenue						
Expenses						
Supplemental Activity						
Revenue						
Expenses						

In short, while the financial reports for the last two quarters of 2003-04 include headings with somewhat similar information, the breakout of the detail changed. As a result, **the detail in the four quarterly financial statements cannot be compared to each other.** Moreover, in the last two quarters the expense detail includes 18 expense lines, including postage (\$1.072 million), but **it does not include contingency**, which was budgeted at \$3.116 million.

Each year's Business Plan includes an explanation of the proposed budget but does not include a recap of significant events that created the variances in expenditures from the approved budget to the actual and/or reprojected amount by year's end. When the Business Plan is presented each year, it should include a simple restatement of where the approved budget started, what significant amendments were made to the approved budget and why, and how the year-end actual expenditures compare. This comparison should not be confused with the monthly "re-projection" of expenditures. The approved budget should remain static unless changed through formal action of the Board. The explanation of the variance from approved to actual is needed not just for the bottom line, but for the major categories of expenditures. By providing this information each year in the Business Plan and the proposed budget, any oversight body has a clear record year to year of how well EdFUND's planning and budgeting processes worked, and what had a significant impact on those plans. There should be a clear record of what the plan (budget) estimated would happen, what major adjustments had to be made and why, and where the plan ended up. Otherwise, it becomes increasingly difficult to quantify the quality of EdFUND's budget and planning if the point of comparison is not static. Retracing the events of the prior year is an important step in a strategic planning cycle as is an important source of information for continuous improvement. Understanding what was not foreseen the year before and how EdFUND responded can strengthen EdFUND's ability to plan for the future.

EdFUND Could Improve the Consistency of Its Budget Reports. As much as possible, consistent figures should be presented across reports, especially bottom-line budget figures. **Public Works** had difficulty tying an EdFUND aggregate budget figure to an EdFUND narrative. Specifically, EdFUND reported that the Loan Program had \$77.7 million in expenses from standard activity.⁶³ The Monthly Budget to Actual printed 10/19/2004 ("EdFUND All Loan Program") shows actual YTD expenditures of \$82,847,865 for the loan program. In addition, EdFUND's "Statement of Revenues, Expenses and Changes in Fund Net Assets for the Twelve Months Ending September 30, 2004 (preliminary close 10/26/04) also lists Loan Fund Operating Expenses as \$82,847,865.

This is a difference of \$5.1 million between the narrative and both the budget printout and the monthly financial statement. When asked about the difference in

⁶³ CSAC/EdFUND 2003-04 Financial Year in Review as of September 30, 2004, as presented to the Finance & Budget Committee on October 29, 2004, p. 3, and again in EdFUND, *Review of 2003-04 Performance*, Presentation to Board of Directors (November 8, 2004), Slide 12.

figures, EDFUND provided information regarding the calculations, which resulted in a figure closer to the \$77.7 million; however, discrepancies remained. EDFUND provided the following explanation:

“As reiterated during the teleconference last Friday, January 7, with Ed Chase, the ORACLE reports for EDFUND are merely a subset of the entire loan program financials. *(Please refer to Item #1 – Bullet 3, provided December 24, 2004).*”⁶⁴

The December 24, 2004 item stated:

“Operating Fund financial statement mapping guide indicating the expenses that post to Oracle and what post to Calstars using the current financial statement format as the template [is enclosed].”

After reviewing the documents, the \$77.7 million figure appeared in the CSAC Operating Fund/EDFUND & Federal Fund 2003-2004 Variance Report for the Twelve Months Ending September 30, 2004, annotated as “preliminary, 10/26/04.” However, the following figures also were presented in financial documents:

- After adjusting EDFUND’s 10/26/2004 financial statement figure of \$82,847,865 to omit ‘Restricted fund activities’ and ‘EDSHARE’ from the Loan Fund column, the total was **\$76.3** million.
- Actual expenditures from the Oracle printout (12/23/04) were **\$76** million.
- The EDFUND/CSAC financial statement for the twelve months ending Sept. 30, 2004 (provided with the Dec. 24th documents) showed actual expenditures of **\$76.8** million.

Each of the different documents provided showed different amounts, only one of which matched the October 29, 2004 statement that Loan Program expenses totaled \$77.7 million for FY 2003-04. The range of difference was from \$900,000 to \$1.7 million.

In a September 30, 2004 document (Proposed Budget for 2004-05), the remaining contingency budget balance was at \$1,341,000 for FY 2003-04. However, the contingency list of projects for FY 2003-04 totaled \$834,000 (out of \$3,116,063 budgeted), leaving a balance of \$2,282,063 – a difference of \$941,037 between the balances in the two reports. EDFUND’s explanation for the difference in contingency budget expenditures between the September report and the list of items provided in November 2004 was that staff had overestimated in September the amount of contingency funding that would be encumbered. This overestimation occurred even though September is the last month of EDFUND’s fiscal year, and the overestimation at that point in time was for nearly one-third of the total contingency amount. According to

⁶⁴ Memo dated January 11, 2005, from Janie Holland, Director of Administration, EDFUND, to Kathleen Stanley, AGPA, CSAC, re: Response to Additional Follow Up Questions.

EDFUND's budget and forecasting process, there should have been a recalibration on high-level expenditure categories in August. The recalibration should have resulted in more accurate figures being presented in the September report.

Other Reporting Issues. In addition to the more detailed findings discussed in this chapter, **Public Works** identified other issues that EDFUND and CSAC could address to strengthen the quality of financial operations.

- When EDFUND was first created, it made use of Calstars, the State's finance and accounting system maintained by the Department of Finance. This was done for convenience and as a temporary measure. During that period, since it was the same State system used by CSAC, then CSAC had access to EDFUND's financials. However, as EDFUND's financial system has evolved off Calstars and onto its current Oracle platform, CSAC no longer is able to access EDFUND's financials directly.⁶⁵ Instead, CSAC must wait for EDFUND to notify it when reports are available on a shared drive, or receive reports in hard copy. CSAC does not have access to Oracle to view reports, or to run specialized queries. CSAC has not formally requested access to EDFUND's Oracle system.
- Financial Reporting does not report up through the EDFUND Controller, but instead reports directly to the EDFUND Chief Financial Officer. As a result, the Controller does not have direct authority over financial reports, including budget documents, issued by EDFUND
- The Aperture system, used to track EDFUND assets, is nine years old and is not capable of retaining the location history of assets. Each scan of a unique item overwrites the previous scan, thus causing problems when an asset becomes damaged or misplaced.⁶⁶ EDFUND's Technology Support Services has started working towards a solution for this problem.

Operational Efficiency. Finally, in the course of reviewing financial operations, the following issues surfaced that are not directly related to financial reports or operations, but that **Public Works** believes merit discussion.

- Records retention for both EDFUND and CSAC is handled by the same staff person; however, the two organization's systems do not interface. A lack of coordination between the two organizations led to re-programming for a coding system to identify student records by a unique number other than their social security number. The two agencies developed a different

⁶⁵ January 9, 2005 Telephone interview with Janet McDuffie, Chief of Administrative Services, CSAC.

⁶⁶ December 7, 2004 Interview with Bill Nankervis, Facilities Operations Manager, EDFUND, Rancho Cordova, CA.

number of digits for the code so the system had to be changed to accept and tie the two different codes to each student.⁶⁷

- EDFUND provides its monthly expenses to CSAC in hard copy through interagency mail rather than electronically.
- CSAC reconciles equipment reports from hard copies that are sent from EDFUND, rather than working from electronic copies that can be more easily sorted and reconciled.

Recommendations

EDFUND's final budget by major program or expenditure category should be subject to Commission approval. As the process currently exists, the Commission approves an overall expenditure level early in the budget process. However, the budget process does not include a step for the Commission to approve or change EDFUND's budget allocations by program and by major category (such as contingency and variable pay) once the Board has granted its approval. While the overall level of expenses is a significant item in EDFUND's operations, the more meaningful impact and consequences result from how expenses are allocated throughout EDFUND's operations. CSAC can better integrate the planning and budgeting for both CSAC and EDFUND if CSAC has a role in the allocation of resources for both entities. Now that both entities must operate out of the Operating Fund, they could benefit from a governance system that fully supports more integrated planning and budgeting. Ideally, CSAC and EDFUND should be operating to achieve the same program goals. Ensuring that the oversight entity has a role in the on-going allocation of resources to achieve those program goals should not eliminate flexibility on the part of the auxiliary, but rather should enhance support of joint goals and objectives.

Eliminate the contingency budget line item. An analysis of EDFUND's budget over the last three years indicates that flexibility has been built into the budget in the three expense objects of consulting fees, computer consulting fees and program grants & awards. The amount of flexibility in these three items has allowed EDFUND to respond to changing circumstances. There is no prior Board approval of the use of contingency funds. The kinds of purposes for which the contingency budget has been used seems to indicate that, in some cases, the expenditures might have been anticipated or might have been postponed until the next fiscal year, such as the \$97,000 upgrade of EDFUND's conference room in 2002-03; or a \$390,000 consulting contract in 2002-03. It is difficult for EDFUND overseers to follow how the contingency funds are used based on the current reporting methods. Expenditures from the contingency budget require changes in the approved budget figures for other categories, thus removing the approved budget as a static point of reference against which planning quality can be gauged. The current process of including a contingency budget in the calculation of the

⁶⁷ December 8, 2004 Interview with Julie Kanoff, Manager, Imaging and Records Management, EDFUND, Rancho Cordova, CA.

Loan Program Surplus target metric does not enable this metric to reach its full potential as an assessment of organizational achievement.

Given the issues cited above, CSAC should consider eliminating EdFUND's contingency budget. EdFUND already provides quarterly financial forecast updates to the Board. In the event EdFUND needed additional funds to meet a critical unanticipated need that could not wait for the next fiscal year, it could bring its request for emergency funding to the Board along with its updated revenue forecast.

If the contingency fund is not eliminated, it should be modified to strengthen its utility and effectiveness. If CSAC chooses to retain the contingency budget, EdFUND should significantly improve the contingency budget's utility and effectiveness, and enhance the Commission's oversight of the contingency budget by:

- Re-examining the 3 percent presumption. EdFUND now has four years of actual contingency fund expenditure data. The Commission and Board should re-examine the size and necessity of the contingency fund. Data indicate that the fund could be set below \$1 million.
- Requiring approval by the EdFUND Board and/or CSAC regarding the use of contingency funds in a manner that is consistent with guidelines.
- Improving reporting of contingency fund expenditures in a way that clearly and explicitly shows how those funds are being spent as they are being spent. This may require removing "contingency" as an expenditure line item and moving it to revenues, since it clearly operates more like a fund than an object of expense. Expenditure plans for contingency items could be updated at least quarterly, or more frequently as the budget process requires.

Improve reports by including explanations that explain differences and tie one report to another. EdFUND's various narrative and financial reports must be as consistent as possible. When inconsistencies arise and bottom-line figures do not tie across reports, the reports need to contain a clear explanation of the cause for the difference. This will allow EdFund's overseers to track those changes more easily and ensure quality control.

Consider merging EdFUND financial operations under CSAC. Creating one overall finance office for both CSAC and EdFUND enhances the opportunity for additional transparency and budget accountability. Functions to consider combining include cash management, financial systems, general accounting, payroll, accounts payable, accounts receivable, budget, financial reporting and analysis, and treasurer. Merging these financial functions would strengthen CSAC's ability to conduct its mandated oversight responsibilities because it would create greater access to, and responsibility for, EdFUND financial information. If EdFUND financial operations were within CSAC's Management Services Division and ultimately reported up through

CSAC, then CSAC staff would not have to make formal requests to EdFUND for the information CSAC needs to perform its oversight functions. CSAC could access EdFUND's financial system on Oracle for timely tracking of expenditures and for budget analysis and oversight. Direct access to EdFUND's financial information would allow CSAC to run its own analyses rather than having to rely on EdFUND for both the information and the explanation of the information that EdFUND provides. Extensive legal analysis would be necessary to ensure that any such joint or merged arrangement would preserve EdFUND's status as a separate non-profit, and would need to examine contractual and personnel considerations, among others.

It should not be assumed that such a merger of financial operations would result in substantial savings, given that staff will be needed to maintain both the Calstars and Oracle financial systems to produce the required State and federal reports. Some savings over time may be realized through salary savings from any differences between EdFUND and CSAC salaries for comparable functions.

If the Commission does not choose to merge or otherwise more closely unify EdFUND's and CSAC's financial operations, then it should consider making the following changes:

Provide CSAC access to view EdFUND's finances in Oracle. Given CSAC's oversight role and the interdependence of EdFUND and CSAC, providing CSAC access, even limited viewing access, to EdFUND's financial system will improve operational efficiency and can only serve to enhance the cooperation and coordination of the two entities. It also would eliminate the need for CSAC to receive hard copies or wait for copies of EdFUND's monthly budget and financial statements. EdFUND has indicated its willingness to provide this access.

Reorganize financial operations at EdFUND so that Financial Reporting reports to the Controller. The inconsistencies across financial reports cited above could potentially be minimized if all financial reports are reviewed by the Controller. The EdFUND Chief Financial Officer mentioned that he was thinking about making this change. In the interest of quality control, it makes sense to do so.

Move forward as quickly as possible to correct the weakness in the Aperture system. Given the value of assets at CSAC and EdFUND, there needs to be a way to track the history of locations for individual assets, especially in the event of missing assets. Aperture needs to be able to provide a history and use of each asset under EdFUND and CSAC control.

Improve coordination of records imaging and management between CSAC and EdFUND. Both agencies would benefit from better coordination of records imaging changes and any conversions of records to compatible formats. Informal coordination may not be adequate. EdFUND and CSAC should establish a formalized, ongoing team that will meet regularly to review planned or proposed projects, implementation details,

and evaluation of problems or issues in records creation, retention, imaging and management.

Contracts Review

Scope of Review

Public Works was asked to review a sample of legal documents, such as vendor contracts, to assess the adequacy of the documentation and compliance with EDFUND policies and to address the need for any changes.

Methodology

In order to assess the adequacy of and adherence to contracting policies and procedures at EDFUND, we reviewed the Operating Agreement, the log of executed contracts submitted by EDFUND to CSAC, EDFUND written policies and procedures, and a small sample of representative contracts.

There is one reference to contracting requirements in the Operating Agreement, in Exhibit F: Reports/Invoices/Publications. This exhibit lists certain reports that EDFUND is required to submit to CSAC on a regular basis. While no specific timeframe is indicated, there is a requirement that EDFUND submit a Contract Log on an “ongoing basis and as approved or issued.” Information to be included in the log includes:

- Contract number
- Manager and department responsible for the contract
- Contract start and end dates
- Vendor name
- Description of scope of work
- Contract amount
- Cumulative amendment information, and
- Board approval date if required.

This information is provided to CSAC on a monthly basis, and CSAC has maintained a cumulative list of contracts since the inception of EDFUND.

EDFUND has adopted several separate policies and procedures pertaining to contracting. These include definitions, types of contracting permitted, bidding requirements, documentation and processing requirements, and levels of authority for approvals. EDFUND contracting-related policies include:

- Policy Number 002 – Conflict of Interest
- Policy Number 018 – Procurements/Contracts
- Policy Number 021 – Signature Authorizations

In addition, the following procedures relate to contracting:

- Procedure Number 08.21.01.002 – Review and Negotiate Contracts
- Procedure Number 08.21.01.010 – Review Request for Contract Services Form
- Procedure Number 08.21.01.011 – Draft a Contract
- Procedure Number 08.21.01.012 – Amending a Contract
- Procedure Number 08.21.01.013 – Competitive Bids
- Procedure Number 08.21.01.014 – Finalize Contract
- Procedure Number 08.21.01.015 – Contract Renewal Notification
- Procedure Number 08.21.01.016 – Update Contract Logs

The review of a sample of contracts for this engagement was designed to review the types of documentation established during contract considerations and adherence to EdFUND policies; it was not intended to be an audit of the contracting process. Three sample contracts were chosen to represent:

- A large contract of over \$1 million (noted herein as Sample Contract 1 or Sample Vendor 1)
- A small contract of \$20,000 (noted herein as Sample Contract 2 or Sample Vendor 2)
- A sole source contract (noted herein as Sample Contract 3 or Sample Vendor 3)

Findings

The following observations are based on the information provided by EdFUND and CSAC related to executed contracts, policies and procedures, and review of documentation for the sample contracts.

Contract Volume. According to the Master Log of contracts provided by EdFUND to CSAC on a monthly basis, EdFUND entered into 136 contracts during Fiscal Year 2003-2004. This represented 85 new contracts and 51 amendments. The dollar value of contracts ranged from 14 no-cost amendments to a contract for nearly \$2 million. The majority of contracts (63.2 percent) ranged in value from \$5,000 to \$100,000. (See Table 7.)

Table 7. Distribution of FY 2003-04 EdFUND Contracts (by Dollar Value)

No Cost	\$2,501 – \$10,000	\$10,001-\$50,000	\$50,001-\$100,000	\$100,001-\$500,000	\$500,001-\$1 mill.	> \$1 mill	Total
14	21	48	17	28	6	2	136

The 51 amendments executed by EdFUND in FY 2003-2004 represent 37.5 percent of the total contract activity.

Sole source contracts – contracts in which only one specific vendor is identified and contacted -- are of interest for more in-depth investigation because they represent exceptions to standard procurement best practices. According to the Master List, EdFUND executed 34 new contracts through sole source, or 40 percent (34 of 85) of all new contracts issued for the year. The majority of these sole source contracts also ranged between \$5,000 and \$100,000: Three-quarters of all sole source contracts (74.4 percent) fell within this range. The divisions responsible for the majority of the sole source contracts were Information Technology and related IT services (11), Legal Services (7), and Finance and Administration (6).

In response to this data, EdFUND later reported that it executed a total of 164 contracts; of these, 105 were new contracts, and 59 were contract amendments, with 32 of the new contracts being issued through sole source. This would indicate that 30.5 percent of new contracts (59 of 105) were issued as sole source and 36 percent of all contract activity was related to amendments (59 of 164). This results in 55.5 percent of all contract activity conducted outside of a competitive bidding process.

Depending on the data used, contract activity breaks out as follows:

Table 8. EdFUND/CSAC 2004 Contract Activity

	Master List	EdFUND
Total contracts	136	164
New contracts	85	105
New Sole Source	34 40% of new contracts	32 30.5% of new contracts
Amendments	51 37.5% of total contracts	59 36% of total contracts
Percent of contracts issued without competitive bidding	62.5%	55.5%

General Contracting Policies and Procedures. EdFUND contract policies and procedures cover critical topics for the initiation and management of contracts. They define procedures for when and how to initiate contract requests, and approval authority for both the initial request and eventual execution of contracts. They specifically indicate the need for three bids for procurements over \$10,000 unless three vendors are not available. They could provide more detailed requirements, however, to describe what information should be contained in justifications and cost benefit analyses in order to provide sufficient information to managers to assist in making informed decisions about the need to contract work out versus completing it in-house. Based on the review of policies and procedures, there does not seem to be organizational standards for what constitutes an adequate cost-benefit analysis, such as an assessment of current organizational capacity, estimates of in-house resources and costs for performing services, what improvement to services a vendor would accomplish, or what costs would be incurred by EdFUND even with an outside vendor.

EDFUND policies do not address the issue of “daisy chaining” in contract processing. This practice artificially establishes separate contracts for similar goods and services in order to circumvent approval processes or thresholds. Generally, organizations can protect against this possibility by clearly defining the requirement that similar goods and services be procured through one contracting process. While there is no evidence that this has occurred at EDFUND, explicit prohibitions against such practices strengthen contracting policies in an organization.

EDFUND has a fairly well-defined conflict-of-interest policy. The policy, however, is not reflected in any documents completed during the contracting process. No affirmative statement is made that there is no conflict of interest when processing a contract; that is, no responsible official, whether the contract manager or any of the individuals required to sign-off on a given contract, are required to attest in writing that they are free of any conflicts as to the proposed vendor. Again, while the scope of our review did not look for evidence that any conflicts existed or occurred previously, EDFUND could strengthen its procedures and better safeguard the organization by requiring an affirmative statement of no conflict and delineating penalties should conflicts be identified and determined.

No up-front action is required, nor is any role identified for CSAC, in the Operating Agreement for the contracting process at EDFUND. EDFUND Policy Memo 018, however, does identify a consultative process in an “Urgency Provision” contained in current policy, which was approved by the EDFUND Board of Directors in 2000. A sole source contract over \$100,000, requiring urgent action, can be executed between Board meetings after consultation and approval is obtained from EDFUND’s President, the Board Chair, CSAC’s Executive Director, and the Commission Chair.

Under-Use of Competitively Bid Contracts. Competition in procurement and contracting is designed to accomplish a number of aims that will benefit an organization. Competition often leads to a better price; when vendors compete for a service, they typically will reduce prices in order to win a contract, saving the organization money. In addition, competition also can yield better results: when vendors are given an opportunity to suggest solutions, organizations can pick and choose from solutions that best address the problems that they are seeking to remedy. Competition also encourages vendors to incorporate more state-of-the-art goods, services, or processes in an effort to win a contract. Finally, with public sector entities, competitive bidding increases transparency, heightens public scrutiny and awareness, and reduces the opportunities for conflict of interest and self-dealing.

Recognizing the potential for cost savings and solutions that offer better value, coupled with the percentage of sole-source and/or no bid amendments, indicates a need for more competition in the procurement and contracting practices. As noted above, depending on which contract total numbers are used, between 30.5 and 40 percent of EDFUND’s contracts in FY 2003-2004 were new sole source contracts, while an additional 36 to 37.5 percent were contract amendments. Thus, between 55.5 and

62.5 percent of all EDFUND contracts last fiscal year were not subject to competition. In contrast, in FY 2003, only 13.8 percent of all federal government contracts for goods and services were executed without full and open competition (43,131 out of 313,399 contracts).⁶⁸

While every procurement need not be competitively bid, some of these non-competitively bid contracts may represent the possibility of lost opportunities for EDFUND. A well-conceived procurement process need not be unduly time-consuming or labor-intensive. In fact, a well-conceived procurement can aid effective program planning. A program planning process that works backwards from a desired end and incorporates an effective procurement strategy often can save an organization considerable money and provide better value and solutions over the duration of the contract. EDFUND entered into more than \$16.6 million in contracts last fiscal year. Had EDFUND saved even 3 percent on its own contracts by more effective use of competitive procurement strategies, it would have realized roughly \$300,000 in savings – savings that should be important to EDFUND, a quasi-public agency that could put such additional funds to use in the service of students and colleges.

Single and Sole Source Contract Justifications. EDFUND policies establish additional requirements for single and sole source contracts to increase the level of scrutiny and approval authority required. A separate memorandum is required to justify the reason for contracting with a single or sole source vendor. EDFUND policy defines single source contracts as a procurement or contract for goods and/or services where only a single business enterprise is able to provide the specified goods and/or services. EDFUND policy defines sole source contracts as a procurement or contract for goods and/or services where only one vendor is given the opportunity to bid for the specified goods and/or services because of existing business requirements or limited sources. Single and sole source contracts over \$50,000 require approval from the President; contracts over \$100,000 require Board approval. Similar to the observation noted concerning general contracting policies, EdFund does not provide much guidance on what would be adequate justification for sole source contracts. The policy could be improved by citing examples and defining the types of circumstances in which sole source contracting would be appropriate.

In the small sample of contract documents that we reviewed, EDFUND's requirement that a justification memorandum be included in the sole source contract packages was met, however, the written justifications provided little information to enable a decision-maker to assess whether the sole source contract was justified. For example, one justification stated in its entirety:

[Sample Vendor 2] has been chosen to once again create and administer President Becky Stilling's confidential evaluation for the PEN Committee. No other bids were solicited as [Sample Vendor 2] affords us the benefit of

⁶⁸ Committee on Government Reform Minority Staff, *Noncompetitive Federal Contracts Increase Under Bush Administration* (May 2004), p. 3.

an established historical data collection, competitive fee basis structure, and is able to meet our deliverable deadline for Committee review.⁶⁹

In another example [Sample Vendor 3], the sole source justification for the contract, at face value, seemed more thorough:

EDFUND has experienced delays in implementing its retirement plan and welfare plan due to difficulties in completing the plan documents. To ensure that the final plans meet all legal requirements, it would be prudent to arrange for outside counsel to review the plans and the current administration of the plans.

In my attempt to find suitable outside counsel to assist EDFUND in this matter, I was referred to [Sample Vendor 3]. He was highly recommended as an expert in employee benefit matters. After review of his credentials, it was apparent that he indeed had the required expertise to assist EDFUND. His hourly rate is compatible with hourly rates for attorneys in the Sacramento area with his level of expertise.

Based on the foregoing, I recommend engaging [Sample Vendor 3] to represent EDFUND regarding its retirement plan and welfare plan matters, and such other employee benefit matters that might arise.

For Sample Vendor 3, originally a \$20,000 contract, the statement provided might well be enough to satisfy the requirement for sole source justification. The justification, though, may not adequately support amendments to the original procurement as the initial \$20,000 contract is amended a number of times, increasing the dollar value from \$20,000 to \$345,000 – a 17-fold increase. Given that future amendments were justified along the lines of allowing the contractor to complete his work, the original justification may appear insufficient.

Contract Amendments. As with single and sole source contract policies, additional requirements pertaining to contract amendments exist. The contract amendment requirements – “required supporting documents as if the amendment constituted a new contract” – are general and not defined in enough detail to make judgments about whether or not a proposed contract meets threshold standards. Justifications that we reviewed on a number of contract amendments were so general as to appear ineffective to for the purposes of assisting decision-makers in assessing the worthiness or need for the amendment. As noted above for Sample Vendor 3, one justification that we reviewed read, “an amendment needs to be processed to allow us to pay this firm to complete the documents needed to finalize these plans.” That sentence was used to justify a contract amendment that increased an initial \$20,000 contract by an additional \$75,000. That contract subsequently was amended by another \$200,000 using the exact same language (“Based on the review results, an amendment needs to be processed to allow us to pay this firm to complete the

⁶⁹ Although the contract requisition cover sheet indicates that a sole source justification is attached, none was included. The quoted language comes from an attached cost benefit justification memo, which presumably served both the sole source and cost benefit justification purposes.

documents needed to finalize these plans.”). The contract was amended yet again for \$50,000 based on the following conclusory justification:

[Sample Vendor 3] was previously contracted to advise EdFUND with respect to its retirement and welfare plans. A contract amendment needs to be entered into to ensure that we continue to receive ongoing advice in the area of ERISA compliance. Changing firms at this time would not be cost effective or an effective use of time.

Maintaining Master Contracts List. The Alpha Master List of contracts did not match the information received from EdFUND for one of the three vendors in the sample. The discrepancy involved a \$200,000 amendment to a contract with Sample Vendor 3 (99-134a). Although this information was provided, the amendment did not appear on the Master List. Additionally, the Master List provided basic information that does not sufficiently identify other important contract information, such as noting whether the contract was initiated by CSAC or EdFUND.

Recommendations

Improve the initial assessment of need for a contract. As the oversight agency for EdFUND, CSAC should participate in the development of policy concerning when contracts are appropriate to support operations. Guidelines can be improved to better detail the reasons for contracting versus performing the identified work in-house. Examples of policies that might be developed include:

- Separate and detailed requirements for contracting for goods versus services.
- Identification of various service requirements that lend themselves to contracting based on EdFUND’s experience and capabilities.
- Pre-defined instances when contracting is needed, for example to meet legislative timeframes for implementation, or when specialized services are required.

Establish a defined two-stage process, especially for larger contracts. It was difficult to determine from dates on documents whether or not the decision on the need to contract was made prior to drafting a contract to send for appropriate signatures. Especially for larger contracts (such as those over \$50,000), there should be a process for management to determine and sign-off on the need prior to drafting paperwork to execute a contract. A National State Auditors Association white paper published in June 2003, *Best Practices in Contracting for Services*, recommends a clear delineation of decision-making in the contracting process. The Association recommends that the decision to contract be a defined exercise involving analysis of need, a cost-benefit analysis, and an evaluation of all options to assist managers in making informed decisions. Establishing a two-phase process enables managers to

determine business needs first, define the goals and objectives of a potential contract, determine the range and number of potential vendors, and assess whether there is a net benefit to contracting.

Enhance requirements for single and sole source contracts. Because competition in procurement and contracting is designed to identify the highest quality goods and services at the best price, single and sole source contracting should be used more sparingly. Sample Contract 2 demonstrates the potential benefits of competitively bid contracts: The bid won by Sample Vendor 2 met all of the desired services at one-sixth the cost of the highest bidder. Furthermore, competition may enable EDFUND to benefit from more state-of-the-art goods and services.

EDFUND may want to consider designing a form for single and sole source contracting that requires specific questions be answered in order to more adequately justify any proposed sole source contracts. Answers could be required to such questions as:

- Is this the only product/service that can meet EDFUND's needs?
- Is this the only vendor that can meet requirements?
- What steps were taken to investigate the marketplace and determine whether more than one vendor was available?
- Why is the price considered reasonable for the goods or services offered?
- What efforts were made to negotiate best price with a single vendor?

Improve policies and procedures for contract amendments. Existing policies should be strengthened by developing more detailed guidance on what information should be submitted to justify a contract amendment. These justifications should be more factual in nature, rather than blanket statements of opinion. In addition, limits on amendments should be established to prevent multiple amendments that increase the value of the contract substantially. Special requirements should be established to further justify the reason for an amendment that includes:

- Has the contractor performance been satisfactory?
- Is the amendment for additional work initiated by EDFUND?
- What is the specific purpose of the amendment?
- Why amend a contract rather than bid for additional goods or services?
- What is the cost/benefit of amending a contract versus bidding for a new one?
- What is the total amount of amendments and/or other contracts with this same vendor over the past 3 years?

The amount and number of amendments should be limited, requiring additional review and approval at certain thresholds. For instance, to safeguard against limiting competition even for pre-qualified contractors, EDFUND might look to California Department of General Services Management Memo 03-10 (May 28, 2003), which limits amendments to one year and not more than 30 percent of the original contract. These

sorts of policies would encourage better management of existing contracts, and safeguard against amending contracts when new bidding would be the best action for EdFUND, taxpayers, and clients.

Require an affirmative statement that no conflict of interest exists. The Contract Requisition Form should be modified to include a statement that no conflict of interest exists for anyone in the selection, review, approval process, and management of the contract being considered.

Require initial and yearly refresher training for all staff and management involved in the procurement and contracting process. Policies and procedures are only as effective as the staff responsible for their implementation. While we did not interview staff involved in the contracting process, best practices dictates the need for ongoing training. Training sessions for staff and managers involved in the procurement and contracting process should be conducted regularly to remind everyone involved in the process of organization policies and procedures. In addition, best practices in contracting and procurement can be highlighted, and policies and procedures modified on a continuous process improvement model. The National Purchasing Institute identifies degree-level professional procurement staff, professional training, and professional certification for managers as key indicators of high-quality procurement and contracting operations. The extent to which EdFUND compares to these standards would require a more in-depth analysis of line staff and supervisors involved in the procurement process and could be incorporated into the next annual performance review.

Ensure the Master List is accurate and that contract files contain all relevant information. CSAC and EdFUND should establish mechanisms to ensure that all contract information is accurately communicated and recorded, including quarterly or yearly cross-checks of contract information against Board minutes or information from other sources, such as independent audits. If the Contract Master List is used to track contract activity, it needs to be expanded to include additional substantive information on the purpose of the contract, process and sign-offs, and originator. In this way, both CSAC and EdFUND have access to contract information for tracking purposes that is more meaningful and useful.

Establish beneficial public procurement goals. As a quasi-public agency, EdFUND's procurement practices reflect upon the California Student Aid Commission, the Governor, and California State government. Although one of the rationales for splitting off EdFUND was to liberate it from onerous State procurement requirements, EdFUND remains a publicly-owned entity responsible for pursuing procurement practices that are not entirely devoid of public benefit. EdFUND should consider establishing by policy procurement goals that are responsive both to the organization's needs and to the public interest. These might include small business procurement goals, goals that encourage contracting with disabled veteran business enterprises, or some effort to extend procurement opportunities to all geographic areas of the State.

Save money and enhance value by competitively bidding more contracts and strengthening contract management. A wide array of innovative, easy-to-use, and rapid procurement strategies have been identified and implemented in the public and private sectors. EDFUND should investigate and implement some of those strategies and train staff to apply them appropriately in order to save money, enhance innovation, and encourage cutting-edge solutions.

Legal Services

Scope of Review

Public Works was asked to assess the efficiency and programs in two divisions – the Legal Services Division and the Finance and Administration Division. The review of the Finance and Administration Division was addressed earlier in Chapter 2.

The EDFUND Legal Services Division employs two attorneys, three employees who staff an ombudsman office, one manager who assists EDFUND staff in developing and maintaining operational procedures in compliance with organizational and external policies, and one legal assistant.

Methodology

As part of this review, we interviewed the EDFUND General Counsel and reviewed related documents, including year end reports, contracts and supporting documentation, and EDFUND policies and procedures.

Legal Department

The EDFUND Legal Department is staffed by two attorneys who function as in-house counsel for the organization. This Department offers legal advice to all divisions within the organization, undertakes legal research, and provides legal opinions as needed. The range of issues addressed by the Department includes, but certainly is not limited to, proper administration of the FFEL Program, contract review, litigation management, corporate governance issues, account resolution, and general business strategy.

Workload between the two attorneys generally is split by professional background and experience. The general counsel tends to focus on issues regarding the EDFUND Board of Directors, regulations, agreements with lenders, agreements with schools, contracts, and corporate governance issues. The assistant general counsel tends to focus on employee issues (including benefits and ERISA concerns), general litigation, and management of outside counsel. The legal assistant generally assists with contract processing. Currently, the Department reviews all contracts entered into by EDFUND.

The Legal Department also includes a staff member who focuses on the development of EDFUND procedures to ensure compliance with state and federal law, as well as internal EDFUND policies.

According to the General Counsel, during the past year, the Legal Department has taken on new risk management functions, including assisting in the development of staff training on risk management-related issues. The General Counsel claims these risk management efforts have helped contribute to a decrease in the number of workers' compensation claims at EdFUND.

Ombudsman's Office

The Ombudsman's Office provides an alternative dispute resolution forum for student loan borrowers. Typically, these involve issues that cannot be resolved easily through standard channels. The leading reasons that borrowers seek the assistance of the Ombudsman's Office are that they want an independent evaluation of their case and that they did not believe that the formal review process was responsive to their needs.

The Ombudsman's Office received 383 new cases in FY 2003-2004, down from 461 new cases in FY 2002-2003 but up from 365 in FY 2001-2002. The Office also closed 363 cases, down from 478 cases in FY 2002-2003 and 388 cases the previous year. (See Table 9.)

Table 9. Ombudsman's Office Caseload Data (by Fiscal Year)

Fiscal Year	New Cases Received	Cases Completed	Avg. Days to Close
2003-2004	383	363	27
2002-2003	461	478	25
2001-2002	365	388	49
2000-2001	518	546	38

Cases are referred to the Ombudsman's Office from a variety of sources. In FY 2002-2003, the U.S. Department of Education was the largest source of case referrals, accounting for 28 percent of all referrals. CSAC and other EdFUND divisions each represented 19 percent of referrals. Borrower-initiated contacts accounted for another 14 percent, while referrals from the Governor's Office and legislative offices provided 11 percent and 5 percent, respectively. During the seven-year period from FY 1995-1996 through FY 2002-2003, however, legislative offices represented 22 percent of total referrals to the Ombudsman's Office. (See Table 10.)

Table 10. Sources of Referred Cases

Source of Referral	FY 2002-2003	Seven Year Average *
Legislative Offices	5%	22%
Direct Borrower Contact	14%	13%
Department of Education	28%	11%
Schools		11%
CSAC	19%	11%
EdFUND Divisions	19%	
Governor's Office	11%	
Other (includes schools)	4%	

* Only the top five referral sources are included here.

Findings

Risk Management. Risk management functions often are kept separate from legal offices in a corporate or public policy environment and are found within divisions that handle insurance or human resources matters. As McKinsey & Co., has noted, “Companies must separate employees who set risk policy and monitor compliance with it from those who originate and manage risk.”⁷⁰ Another more practical purpose of doing so is to ensure that the attorneys are not put into a potential conflict by trying to keep premiums low by conducting their own preliminary legal activities. The potential danger is that a legal division's failure to allow an insurance company to step in at the earliest possible stage of an action may reduce or eliminate the insurance company's management of the situation. Without the option of up-front involvement and control, an insurance company could claim that such actions resulted in a more expensive settlement than if the insurance company had been allowed to handle the situation from the earliest possible stage. In such a case, the insurance company could claim that the organization placed the insurance company at unnecessary risk and, as a result, therefore will not pay the settlement.

Some risk management functions, such as management of insurance contracts, have been undertaken by the Division. Although we recognize that risk management functions are not required to be segregated from legal offices, and that they often can be found there particularly in smaller businesses, we merely raise the issue due to the concerns highlighted above.

Ombudsman's Office Workload. Outreach to schools and improved case management appear to be effectively reducing the number of new cases being referred to this office, as well as the average number of days it takes to resolve a case. In fact, the average number of days it now takes the Ombudsman's Office has been cut in half since FY 2001-2002. Although the workload may not be divided evenly among the Ombudsman's Office staff, the overall workload of the office averages out to one complaint handled per staff member every three days. While some of these cases

⁷⁰ Kevin S. Buehler and Gunnar Pritsch, “Running with Risk” *The McKinsey Quarterly* No. 4 (2003).

involve more intensive staff work, some do not and can be resolved fairly quickly. Thus, the current workload of the Ombudsman's Office may not support the need for three full-time staff. During the last few years, however, those workload levels have changed substantially due to improvements cited above. As a results, the number of new cases received by the Office declined by 26 percent between 2000-01 and 2003-04, and the number of cases actually completed by Ombudsman's Office staff declined by 33.5 percent over the same time period. Thus, the data underlying a staff workload analysis undertaken in 2003 has changed significantly.

Contracts Management. Currently, the Legal Department reviews all contracts executed at EdFUND. While this thorough approach is laudatory, it might be adding unnecessary workload to the two staff counsels.

Policies and Procedures. The Legal Services Division also assists other EdFUND divisions in promulgating policies and procedures. During the course of our performance review, we reviewed a number of policies and procedures, as have been noted elsewhere in this report. We will highlight three important policies and procedures -- conflict of interest, prohibition on inducements, and nepotism -- as these policies can protect, or conversely put the organization at risk, depending on their content and implementation.

Conflict of interest. The two primary issues that ought to be addressed by conflict of interest policies and procedures are disclosure and disqualification -- that is, actual or perceived conflicts should be disclosed, and where appropriate, an employee should be disqualified from participating in a decision if an actual conflict exists or, in some instances, even if a conflict is only a perceived conflict, but one that would reflect adversely on EdFUND and CSAC.

The recently adopted EdFUND conflict of interest policy generally addresses the major concerns that could arise from potential conflicts of interest. Both the conflict of interest policy and its accompanying procedure appropriately place a duty on employees to disclose actual or potential conflicts of interest. In doing so, however, no affirmative action on the part of management is required to seek out and eliminate potential or actual conflicts of interest. An added level of protection would be to require those involved with the procurement to affirm in writing that no actual or perceived conflicts exist.

One additional safeguard that Legal Services might undertake is to develop an annual process through which any employee involved in procurement or contracting for EdFUND receives a summary of the organization's conflict of interest policy and completes a basic personal disclosure form. This would serve an added educational purpose to remind employees of EdFUND's high ethical standards and update within their personnel file the employee's general financial or familial interests in companies, including companies that currently or may do business with EdFUND. This disclosure form could include such areas as:

- Investments in business entities (e.g., stock holdings, owning a business, a partnership).
- Interests in real estate or real property (if the transaction involves real estate).
- Sources of personal income, including gifts, loans and travel payments.
- Positions of management or employment with business entities.

As the Legal Services Division reviews potential contracts, it could do a quick check against the procuring employee's disclosure form as part of its due diligence in approving or disapproving the contract.

Finally, EdFUND should consider adding general language to its conflict of interest policy that explicitly emphasizes that any conflict between an employee's personal interests and his or her public duty will be resolved in favor of the public interest. As a non-profit auxiliary of a State entity, EdFUND ultimately acts in and serves the public interest. The public trust requires employees to understand that their decisions and conduct should be in the public interest and should never improperly advantage any person or company. There could be some statement in the policy and procedure affirming that any conflict arising will be resolved in favor of the public interest.

Prohibition on Inducements. EdFUND has promulgated a policy prohibiting inducements, consistent with the requirements of the Higher Education Act of 1965.⁷¹ This policy prohibits staff from making payments or otherwise undertaking actions to induce schools to participate in the FFEL Program. Taken together with the conflict of interest policy and procedure, this policy would seem to cover most conflict of interest-related issues. However, more generally and perhaps falling somewhat in between the conflict of interest policy and the prohibition on inducements, EdFUND policies seem to lack explicit requirements regarding the improper use of influence. This issue is touched upon somewhat in the policy regarding conflict of interest and again in the inducement policy (specific to outreach to schools). However, to be prudent, EdFUND should enact improper use of influence policies and procedures that address two issues:

- **Employee influence:** Employees should be prohibited from improperly using their influence in order to obtain advantage on behalf of another, including but not limited to a relative, or to affect the proper outcome of any procedure established by EdFUND policy or relevant law. The current EdFUND conflict of interest policy addresses this issue by prohibiting EdFUND employees from influencing "in any manner whatsoever, the selection, award, or decision making related to the administration of a contract or agreement if that participation would create a conflict of interest."⁷²

⁷¹ EdFUND Policy Memo 039, Prohibited Inducements (April 19, 2004).

⁷² EdFUND Policy Memo 002, Conflict of Interest (April 19, 2004).

- **Influence by others:** Employees should refuse to take account of any attempt, by any person whatsoever, including other EDFUND employees, to influence the making of a decision unless the involvement of that person is required by or is consistent with the provisions of the relevant legislation, by-law or policy. Employees must be directed to report the improper use of influence by any person to the President or General Counsel of EDFUND, or other suitable CSAC or EDFUND official.

Nepotism. Although nepotism may not be illegal, it generally presents risks to the organization. Obviously, it increases the potential for workplace disharmony and even employee litigation due to perceived or actual favoritism due to familial status. In addition, excess benefits rules governing non-profits and, in particular, new rules on "disqualified persons" further encourage organizations to consider the risks of nepotism.

To protect the organization, EDFUND's nepotism policy ought to ensure that its employees should never use their influence to obtain appointments, promotions, advancements, transfers, or any other advantage on behalf of a family member or relative, or to affect the proper outcome of any EDFUND policy or procedure. However, the nepotism policy that is currently in place is limited to addressing nepotism as it relates to employment status, that is, recruitment, selection, hiring, and position assignment. It would not cover such potential issues as violations of excess benefits rules, nor does it set forth any process for investigating or remedying nepotism-related issues.

Recommendations

Undertake a thorough organizational risk assessment. The most effective way to manage an organization's risk is to conduct a thorough organizational risk assessment. Although it is possible to undertake such an effort internally, we recommend that EDFUND retain a qualified third party entity to undertake such an assessment. Because it would be an inherent conflict of interest for any of EDFUND insurers to conduct such an assessment, we recommend, consistent with guidance offered by the Non-Profit Risk Management Center, that EDFUND hire a third party firm to do a thorough analysis of the organization's risks.⁷³ This would include reviewing EDFUND's exposure to risk in a variety of areas, including policies, personnel practices, insurance coverage review, and board matters, and offering strategies to mitigate those exposures. We understand that an organizational risk management assessment is underway.

Although the Legal Services staff indicates positive achievements in risk management practices during the past year, the placement of risk management functions within the Division potentially may put the organization at risk in insurance and

⁷³ See, for example, Melanie L. Herman, Nonprofit Risk Management Center newsletter, *Risk Management Resolutions* (January 2, 2005). Available at <http://www.nonprofitrisk.org/tools/archive/strategy010205-p.htm>.

litigation matters. An assessment of the structural handling of risk management issues within the organization should be an additional component of the current risk assessment to ensure the most effective balance between risk reduction and production of optimal results.

Monitor the workload at the Ombudsman's Office to determine proper staffing levels. If current trends continue and the number of new cases and the number of days needed to resolve them continue to decline, EDFUND should conduct desk audits of Ombudsman's Office staff to determine appropriate staffing levels.

Consider requiring dollar thresholds for legal review of contracts to alleviate workload. Should the contracts review process become too onerous from a workload standpoint, EDFUND should consider enacting policies that require legal counsel review and approval at certain dollar value thresholds and for certain types of contracts. For example, legal review might not be required on contracts procuring goods valued at less than \$10,000. However, any efforts to reduce legal review of contracts should be done only in conjunction with increased and continuous staff training regarding procurement requirements and procedures to safeguard the organization.

Develop more comprehensive conflict of interest, prohibition against inducements, and nepotism policies and procedures in concert with appropriate EDFUND business units. The conflict of interest policy should require those involved with procurements to affirm in writing that no actual or perceived conflicts exist. In addition, Legal Services should develop an annual process through which any employee involved in procurement or contracting for EDFUND receives a summary of the organization's conflict of interest policy and completes a basic personal disclosure form. The prohibition against inducements should be expanded to ensure that employees refuse to take account of any attempt, by any person whatsoever, including other EDFUND employees, to influence the making of a decision unless the involvement of that person is required by or is consistent with the provisions of the relevant legislation, by-law or policy and to report any such efforts to influence their decisions. Finally, EDFUND's nepotism policy should be broadened to ensure that its employees should never use their influence to obtain appointments, promotions, advancements, transfers, or any other advantage on behalf of a family member or relative, or to affect the proper outcome of any EDFUND policy or procedure.

Civil Service Promotional Opportunities

Scope of Review

CSAC asked **Public Works** to examine the promotional opportunities available at EdFUND in order to ensure equity in opportunity between the organization's civil service and at-will employees.

Methodology

We conducted interviews with EdFUND and CSAC human resources personnel. We made numerous requests for documents and reviewed internal data and other information regarding personnel practices, historical staffing levels, and job openings.

Findings

Level of Civil Service Employment. When CSAC created EdFUND in 1997 to take on the operational and support services related to the administration of the Federal Family Education Loan Program, EdFUND and CSAC agreed that CSAC would eliminate its loan administration positions and EdFUND would hire the individuals who had held those positions. This transfer is documented in the operating agreement between EdFUND and the Commission. Article II, Section 2.10 – entitled “Civil Service Employees” – states:

EdFUND agrees to take the assignment of existing civil service employees of the Commission assigned to EdFUND as of October 1, 1999, as permitted by law, for the purpose of performing services under this Agreement. EdFUND agrees that it shall treat the identified civil service employees as its own employees, except as required due to their civil service status, including terms and conditions of any applicable memoranda of understanding covering represented employees.

According to EdFUND, 428 EdFUND employees were civil service employees as of January 1, 1997. At that time, civil servants comprised a majority of EdFUND's staff. EdFUND has hired no other civil servants than those who originally transferred from the Commission in 1997; the rest of EdFUND's employees are at-will hires who are not subject to the personnel laws and regulations associated with civil service in California. By the end of FY 1996-1997, the number of EdFUND civil service employees had dropped by nearly one-quarter to 328. By the end of FY 1997-1998, the number of EdFUND civil service employee had dropped another 22 percent, to 256.

Table 11 presents a break-out of EdFUND staff during the last four fiscal years.

Table 11. Percent of EdFUND Staff Who Are At-Will Versus Civil Service

<i>Federal Fiscal Year</i>	<i>Total Staff Count of EdFUND Employees</i>	<i>% (n) of Staff Who Were At-Will Employees⁷⁴</i>	<i>% (n) of Staff Who Were Civil Service Employees⁷⁵</i>
2000-01	629	84.6% (532)	15.4% (97)
2001-02	703	87.9 (618)	12.1 (85)
2002-03	664	89.0 (591)	11.0 (73)
2003-04	655	89.3 (585)	10.7 (70)

Civil Service Employee Dissatisfaction. Article II Section 2.10 of the Operating Agreement also comments on the promotional opportunities afforded to EdFUND's civil service employees. It states:

EdFUND further agrees that for the assigned civil servants who wish to retain their civil service status, it will use its best efforts to make promotional opportunities available to civil service employees on the same basis as at-will employees. EdFUND and the Commission understand that such promotional opportunities are subject to the applicable personnel rules of the State of California.

In 2002, the Commission hired a firm to conduct an employee satisfaction survey of EdFUND's civil service employees. Fifty-eight percent—or 48—of EdFUND's civil service employees completed the survey. The survey results showed that respondents' greatest job dissatisfaction related to a perceived lack of equity in the promotional opportunities at EdFUND. Specifically, 65 percent of respondents selected “disagree” or “strongly disagree” in response to the following two statements:

- Civil service employees at EdFUND are as likely to get promotions as at-will employees.
- Promotional opportunities are made available to civil service employees on the same basis as at-will employees.

Comparison of Positions Held. Currently, 28 – or almost 15 percent – of the 187 job titles at EdFUND are inaccessible to civil service employees because the positions do not have civil service classifications associated with them. In California, civil servants only may apply for job classifications for which a civil service classification exists. Table 12 presents a list of these 28 job titles.

⁷⁴ Data reflects figures in an EdFund document that CSAC faxed to Karin Bloomer on December 6, 2004.

⁷⁵ Ibid.

Table 12: EdFUND Job Titles For Which No Civil Classifications Existed At the Time of Promotion

AVP Compensation, Benefits and HRIS	Ombudsman Specialist
AVP Financial Operations & Controller	Operations Analyst Trainee
AVP, Client Services	Public Relations Coordinator
AVP, Controller Financial Operations	Records Technician
AVP, Human Resources	Sales Support Manager
Director of Strategic Information Systems Planning	Senior Advisor
Director, Default Management Systems	Special Liaison to CEO/President
Director, Corporate Clients	Senior Information Systems Auditor
Manager, Client Services	Senior HR Assistant
Manager, Software Development	Supervisor, Default Management Division
Managing Analyst, Post Default Services	Training and Development Consultant
Office Manager	Vice President, Technology Solutions
Office Manager, Regional Office	Vice President, Public Affairs
Ombudsman	Vice President, Client Services

Notably, the vast majority of these 28 titles are managerial. The lack of civil service classifications for significant EdFUND titles appears to present at last one structural barrier to the promotion of EdFUND's civil servants.

Comparison of In-Place Promotions. There are two types of promotions at EdFUND – in-place promotions and promotions into new or vacant positions. In-place promotions are those in which an employee is promoted to a more senior class within his or her position to reflect greater responsibility and/or experience within his or her existing position. For example, an employee might be promoted to the title of Associate Governmental Program Analyst II from that of Associate Governmental Program Analyst because he or she has worked in the position for three years and is therefore eligible for promotion into a higher class of that position, a commensurate title, and higher salary range.

Table 13 below presents a comparison of at-will and civil service employees that received in-place promotions at EdFUND in the last four federal fiscal years.

Table 13: Percent of EdFUND Staff Who Received In-Place Promotions

<i>Fiscal Year</i>	<i>% (n) of At-Will Employees⁷⁶</i>	<i>% (n) of Civil Service Employees⁷⁷</i>
2000-01	14.4% (77)	12.3% (12)
2001-02	7.9 (49)	17.6 (15)
2002-03	6.4 (38)	5.4 (4)
2003-04	10.4 (61)	1.4 (1)

Table 13 shows that, except for FY 2001-02, a greater proportion of at-will employees received in-place promotions than civil service staff. At least one cause for this difference in in-place promotions may be the disparity in access to the process: As Table 14 demonstrates, generally close to one-third of in-place promotions reflected positions that did not have civil service classifications associated with them. Therefore, civil service employees could not apply for these promotions.

Table 14: Percent of In-Place Promotions For Which No Civil Service Classifications Existed At the Time

<i>Fiscal Year</i>	<i>Number of In-Place Promotions</i>	<i>% (n) of In-Place Promotions with No Civil Service Classification⁷⁸</i>
2000-01	89	30.3% (27)
2001-02	64	28.1 (18)
2002-03	42	19.0 (8)
2003-04	62	35.5 (22)

Comparison of Promotions into New and Vacant Positions. Promotions into new or vacant positions are those in which an existing employee applies for and is hired into a new or vacant position that is more senior than his or her previous position. Table 15 presents a comparison of at-will and civil service employees who received in-place promotions at EdFUND in the last four federal fiscal years.

⁷⁶ Data reflects figures in an EdFund document "Items #5 and #6" that CSAC e-mailed to **Public Works** team member Karin Bloomer on December 10, 2004.

⁷⁷ Data reflects figures in a CSAC document that CSAC e-mailed to Karin Bloomer on December 16, 2004.

⁷⁸ Data reflects figures in an EdFund document "Items #5 and #6" that CSAC e-mailed to Karin Bloomer on December 10, 2004.

Table 15: Percent of EDFUND Staff Who Received Promotions Into New or Vacant Positions

<i>Fiscal Year</i>	<i>% (n) of At-Will Employees⁷⁹</i>	<i>% (n) of Civil Service Employees⁸⁰</i>
2000-01	14.1% (75)	2.1% (2)
2001-02	9.1 (56)	1.2 (1)
2002-03	2.2 (13)	0
2003-04	6.7 (39)	0

According to the data presented in Table 15, in the last four years, a disproportionate number of at-will employees received promotions into new or vacant positions compared to civil service employees. In fact, it is safe to say that civil service employees virtually never receive such promotions. In two of the fiscal years, a state hiring freeze contributed to the lack of promotions, but this alone cannot account for the disproportionate number of fewer promotions in other fiscal years.

Once again, lacking civil service classifications may be one primary cause for this disparity. As Table 16 shows, during the last four fiscal years, between 30 and 50 percent of the promotions into new or vacant positions did not have civil service classifications associated with them.

Table 16: Percent of Promotions into New/Vacant Positions for Which No Civil Service Classification Existed At the Time

<i>Fiscal Year</i>	<i>Number of Promotions Into New/Vacant Positions</i>	<i>% (n) of Promotions with No Civil Service Classification⁸¹</i>
2000-01	77	36.4% (28)
2001-02	57	36.8 (21)
2002-03	13	30.8 (4)
2003-04	39	51.3 (20)

While the lack of civil service classifications for EDFUND positions is likely one reason for the discrepancy between at-will promotions and civil service promotions, another factor may be a proportionately smaller applicant pool of civil servants. As Table 17 shows, of those promotions that reflected positions *with* civil service classifications – those for which civil service staff might be eligible – no civil servants

⁷⁹ Data reflects figures in an EDFUND document “Items #5 and #6” that CSAC e-mailed to Karin Bloomer on December 10, 2004.

⁸⁰ Data reflects figures in a CSAC document that CSAC e-mailed to Karin Bloomer on December 16, 2004.

⁸¹ Data reflects figures in an EDFUND document “Items #7, #8 and #9” that CSAC e-mailed to Karin Bloomer on December 10, 2004.

applied in the last two years, and less than 10 percent of civil servants applied in the two prior years for only 12 of the 85 available positions.

Table 17: Percent of EDFUND Promotions into Positions with Civil Service Classifications that Civil Service Staff Applied For

<i>Federal Fiscal Year</i>	<i>Number of Promotions for Which Civil Service Classifications Existed</i>	<i>Percent (n) of Promotions with Civil Service Classifications that Civil Service Staff Applied For⁸²</i>
2000-01	49	16.3% (8)
2001-02	36	11.1 (4)
2002-03	9	0
2003-04	19	0

It is not clear why civil servants are applying for promotions into classified positions at lower rates than at-will employees. One reason may be that they are happy where they are. Another may be that they are discouraged by the prospects of success: Of the twelve positions for which civil service staff applied in the last four years, only three were filled from their ranks. Still another reason may be the onerous nature of the state's promotional application process, which is discussed below.

Comparison of Promotional Application Process. Because civil servants must adhere to state personnel laws and regulations and at-will employees do not, inequity exists in the promotional application process at EDFUND. At-will employees apply for positions by submitting their resumes and undergoing interviews with hiring managers. Civil service employees face three potential barriers when applying for the same position: First, a civil service classification must exist for the position in order for a civil service employee to apply for it; second, civil service examinations must be available for civil service employees to take at the time of the desired promotion; third, the civil service employee must complete and pass the examination in order to be placed on an "eligible list" as a candidate for that classification.⁸³ Only after these criteria have been met can the civil service employee begin the application process that at-will employees undertake. Importantly, two of the three prerequisite actions cited above are beyond the control of the civil service employee — both the existence of the civil service classification and the availability of a civil service examination.

There are, in fact, cases in which additional bureaucratic hurdles exists for civil service employees who may be eligible for promotion. In some cases, the Department of Personnel Administration (DPA) must first approve the use of a particular classification. A Modified Classification Review attaches to each classification, identifying when the allocation and/or filling of a position by a department requires prior

⁸² Data reflects figures in an EDFUND document "Items #5 and #6" that CSAC e-mailed to Karin Bloomer on December 10, 2004.

⁸³ Pursuant to Government Code Section 18990(a).

approval by DPA staff. This designation determines the need for DPA to approve the use of a classification, whether it is used to promote a current staff member in place or to fill a vacancy. Second, DPA approval of the promotion may be required in some, if not many, instances.

Attempts to Minimize Inequity. In a group interview with Human Resources (HR) staff of EdFUND and CSAC,⁸⁴ these staff indicated that they have made attempts to mitigate the structural inequity that exists in the promotional application process at EdFUND. Specifically, HR staff from the two organizations stated that they work together to:

- Disseminate early announcements of job postings so that civil service employees have time to take the relevant civil service examination.
- Distribute e-mails to civil service employees about job openings at both EdFUND and CSAC.
- Hold discussions of equity issues during quarterly operating agreement meetings between EdFUND and CSAC.
- Offer assistance with interview preparation and post-interview debriefings to improve subsequent attempts at promotions through the Personnel Officer for CSAC.

In addition, CSAC's HR staff noted that there had been a practice of asking managers whether any civil service employees were eligible for promotion, so that HR staff could ensure that exams were ready for those employees to take as part of the promotional process. Staff indicated that this practice was discontinued during the state's three-year hiring freeze.

None of the staff cited any actions that have been taken to reduce the number of positions at EdFUND that lack related civil service classifications.

Recommendations

Work with CSAC and the Department of Personnel Administration to obtain civil service classifications for all positions posted for hiring or promotion at EdFUND. An inequity exists between the promotional opportunities of at-will and civil service employees at EdFUND due to the lack of civil service classifications associated with EdFUND positions. Because civil servants cannot apply for positions that lack classifications, EdFUND's civil service employees have access to fewer titles and positions than their at-will counterparts.

⁸⁴ Group interview held on November 10, 2004 with Wendie Doyle, Vice President of EdFund's Legal Services Division and General Counsel to the organization; Doreen Hoops, Vice President of EdFund's Human Relations; and Darla Engler, Personnel Officer, of CSAC.

To mitigate this inequity, we recommend that EdFUND and CSAC work together to identify the steps necessary for establishing civil service classifications for as many of the 28 titles presented in Table 10 as possible and seek the assignment of classifications where feasible. We recognize that there are considerable limitations to this recommendation: The recent State hiring freeze led to a moratorium on the development of new classifications. Similarly, the State has been moving in the direction of eliminating or condensing classifications. We also recognize that the majority of EdFUND's positions lacking a comparable civil service classification are for positions located outside of California. Nevertheless, to the extent possible, CSAC and EdFUND should continue working together to classify what remaining positions they can. In addition, EdFUND should ensure that any and all new positions at EdFUND are assigned a civil service classification within reasonable limits. We further recommend that EdFUND develop a written policy to this effect in order to codify the organization's commitment to equal promotional access.

Reinstate early reviews of possible promotions and identify and advertise the civil service examinations that would be required for civil service employees to pursue those promotions. Prior to the state hiring freeze, HR staff at the Commission followed a practice of working with EdFUND managers to identify those civil service staff who were potential candidates for promotion and then arranging for civil service examinations specific to the relevant classifications. By doing so, HR staff helped to minimize delays in requisite examinations, thereby increasing civil service employees' chances of being considered for promotion during limited windows of opportunity. We recommend reinstating this practice, but doing so as a joint effort with EdFUND HR staff, who arguably should take lead responsibility in this process. We further recommend documenting this practice as an EdFUND policy, underscoring again EdFUND's commitment to equal promotional access.

Executive Management Team: Compensation Assessment

Scope of Review

Public Works was asked to review the process and metrics of the EDFUND Executive Management Team, including management salaries, and to perform a comparative analysis of similar organizations to determine the reasonableness of current management oversight.

Methodology

Public Works reviewed information concerning the Executive Management Team compensation package, including both salary and bonus plan. EDFUND provided information on the levels of base salary for Executive Management Team members from Fiscal Year 2001-2002 through Fiscal Year 2003-2004. Extensive information also was received concerning the Executive Management Team Bonus Plan in the form of e-mails, memos, EDFUND policies and procedures, the Operating Agreement, and the annual Business Plan. Current EDFUND levels of compensation and the process used to determine and implement the Bonus Plan were assessed. In addition, where possible, peer organization information was reviewed.

Salaries

According to EDFUND, the salary grades and ranges for all EDFUND positions were adopted by the initial Board of Directors in 1997, based on the work of an outside compensation consulting firm. The EDFUND Board of Directors has delegated decisions regarding the salaries of Vice Presidents to the President. Currently, salaries for the Vice Presidents are set by the President and fall within the established range for that position. Raises are determined by the President, following the same performance evaluation process used to evaluate all EDFUND at-will employees. The President considers the performance evaluation results, the employee's relative place in the pay scale, and the results of a market comparability study in making the determination of merit increases. The President informs the Chair of the Board of her salary determinations each year. The comparability study is commissioned by the EDFUND Board of Directors and conducted by an outside compensation firm as part of the Directors' due diligence in complying with the Internal Revenue Services' regulation on Excess Benefit Transactions.

The President's salary and any merit increases are determined by the Board of Directors. A comprehensive evaluation is conducted, involving a survey that is sent to key EDFUND stakeholders, the results of which the Board considers along with the overall company performance and the comparability data required under Internal Revenue Service regulations.

Base Salary Comparisons to Peer Organizations. Salary comparison information from peer organizations is difficult to obtain. Nevertheless, because EdFUND is a non-profit and must file as such with the IRS, some comparative information is available through the “990” filing. We recognize the limitations of this data and comparisons, and therefore do not draw any conclusions from the data. It is presented to provide some general gauge of management positions and compensation at EdFUND as compared to peer organizations of similar size and non-profit structure. Table 18 provides data for EdFUND compared to the three similar non-profit organizations closest in size: United Student Aid Funds, Inc. (USAF), Great Lakes Higher Education Guaranty Corp., and Texas Guaranteed Student Loan Corp. This data covers salary figures from FY 2001-02. Due to limitations on the availability of data, this is the most recent year for which we can make full comparisons using comparable information from peer organizations. The following observations can be made:

- The EdFUND President’s salary is within range for these four organizations, significantly lower than USAF – which is to be expected based on size – but comparable to those earned by the heads of Great Lakes and Texas, organizations closer in size to EdFUND.
- The salary of the EdFUND Vice President for Finance and Administration is comparable to USAF though significantly higher than Texas. Other Executive Management Team salaries are generally higher than Texas and significantly higher than Great Lakes.
- The EdFUND Executive Management Team consists of 9 positions, second in size only to Texas, which features a 10-position executive team.
- EdFUND’s total Executive Management Team salaries of \$1.65 million exceed those of USAF by 7.2 percent (\$1.54 million). USAF is recognized as the largest guaranty organization in the country, with total revenues about four times that of EdFUND.
- Compensation for EdFUND’s five highest-compensated employees (apart from Executives and Officers) totaled \$637,791. This was:
 - 82.4% above Great Lakes;
 - 17.1% above USAF; and
 - 13.9% above Texas.

We also observed from the data that EdFUND has the highest number of employees earning over \$50,000; even ignoring a possible anomaly in data from USAF and Great Lakes, EdFUND has 48 (16.0%) more than Texas. Although we were not tasked to examine line staff salaries and compare them to other competitors, this might be an issue for the Commission to examine more closely in the future to see whether

the presence of higher salaried staff has yielded a commensurate level of performance over similarly-situated competitors.

Table 18: 990 Comparison (FY 2002 Salaries)⁸⁵

	EDFUND	USAF	Great Lakes (2001)	Texas
Line 1: Government Contributions	0	\$103,230,915	\$0	\$0
Line 2: Program Service Revenue including government and contracts	\$89,127,696	\$223,864,643	\$66,987,866	\$128,023,014
Line 12: Total Revenue	\$89,402,137	\$351,267,900	\$69,522,649	\$139,421,384
Line 21: Net Asset or Fund Balance end of year	\$26,632,320	\$436,211,699	\$56,392,490	\$157,191,513
Line 25: Compensation of Officers	\$1,639,588	\$1,759,027	\$178,869	\$1,318,761
Line 26: Other salaries and wages	\$37,864,466	\$3,182,803	\$5,861,848	\$35,341,489
President	\$240,214	\$499,418	\$375,595 (2002)	\$186,451
VP Finance/CFO	\$218,453	\$230,287	\$108,048 (2002)	\$133,592
Senior VP Admin				\$132,680
VP General Counsel	\$204,122	\$219,436		\$102,600
Senior VP Gov & Industry Relations		\$237,972		
VP Human Resources	\$147,274			
VP Technology**	\$160,000			\$132,770
VP Loan Operations	\$188,980			\$87,300
VP External Relations	\$197,012	\$198,337		\$112,034
VP Default Management	\$142,553			
VP Product Research	\$151,094			
VP Policy & Compliance		\$153,577		\$103,229
Chief DA/Claims			\$80,763 (2002)	
VP Audit				\$102,834
VP Collections				\$92,590
Total Compensation EMT	\$1,649,702	\$1,539,027	\$513,976	\$1,186,080
Total # Members of EMT	9	6	4	10
Schedule A Part I: Comp 5 Highest Paid	\$139,395	\$95,469	\$84,468 (2002)	\$142,416
	\$137,029	\$97,185	\$65,434 (2002)	\$112,807

⁸⁵ Information on the revenues and assets for Great Lakes was not included on the 2002 Form 990 published. Therefore, to provide an approximate understanding of the size of the agency, 2001 revenue and assets were used. Compensation figures are from 2002.

Table 18 continued				
990 COMPARISON (FY 2002 SALARIES)⁸⁶				
	EDFUND	USAF	Great Lakes (2001)	Texas
	\$117,067	\$105,033	\$55,108 (2002)	\$106,337
	\$123,347	\$135,103	\$54,780 (2002)	\$99,797
	\$120,953	\$111,658	\$54,175 (2002)	\$98,499
Total 5 Highest Paid	\$637,791	\$544,448	\$313,965	\$559,856
Schedule A Part I: Total # others over \$50,000	347	26	1	299

EDFUND Salary and Bonus Compensation. Through a CSAC Policy Statement and Guidelines Memo, "EDFUND Incentive Compensation Plans" (August 12, 2002), the Commission delegated responsibility to propose the amounts of Executive Incentive Compensation payment to the EDFUND Board or its designated committee. That memo requires the EDFUND Board to provide the Commission's Executive Director with documentation that details the overall performance of EDFUND and an assessment of the individual performance of the corporation's President at the end of each fiscal year. Thus, the Board is responsible for "recommending the proposed incentive compensation amount, if any, for the President and the total incentive compensation amount for the EMT."⁸⁷

Salary and bonus information was provided by EDFUND for Fiscal Years 2001-2002 and 2002-2003. Because bonuses were not determined at the time of the submission, Fiscal Year 2003-2004 data included salaries only. Table 19: Salary and Bonus over Multiple Years presents information for the Executive Management Team. An assessment of salaries reveals that:

- The EDFUND President received an average of 8.47 percent salary increase over two years from FY 2001-02 to FY 2003-04: 8.82 percent in FY 2002-03 and 8.11 percent in FY 2003-04.
- The Vice President & General Counsel, Legal Services Division and Vice President & Chief Financial Officer, Finance & Administration Division, received the second highest increases in FY 2002-03 (7.94 percent and 7.19 percent respectively), however they received no increases in FY 2003-04.

⁸⁶ Information on the revenues and assets for Great Lakes was not included on the 2002 Form 990 posted. Therefore, to provide an approximate understanding of the size of the agency, 2001 revenue and assets were used. Compensation figures are from 2002.

⁸⁷ "EDFUND Incentive Compensation Plans" (August 12, 2002).

- Other than the President, the Vice President for Default Management was the only Executive Management Team position to receive an increase (3.84 percent) in FY 2003-04.
- The Vice President, Technology, shows no increase, perhaps because the current incumbent has been with EDFUND only since May 2003.

Bonus information for two years, FY 2001-2002 to FY 2002-2003, shows that:

- Executive Management Team bonuses in 2001-02 ranged from a high of \$70,000 for the President to \$23,000 for the Vice Presidents for External Affairs and Human Resources.
- Bonuses in FY 2001-2002 were 41.18 percent of salary for the President and approximately 37 percent of salary for the Vice Presidents of the Legal Services Division, Finance and Administration Division, Default Management Division, and Public Affairs Division. The Vice President of Human Resources received the lowest bonus at 18.49 percent of salary. Reasons for the fluctuation in bonuses were not provided.
- With the exception of the Vice President for Technology, in FY 2002-03, bonuses were approximately 19% of salary for all Executive Management Team positions.
- The total bonus pool for FY 2001-2002 equaled \$338,000; for FY 2002-2003, it equaled \$188,478.

TABLE 19 SALARY AND BONUS OVER MULTIPLE YEARS

	01-02 Annual Salary	01-02 Bonus	01-02 Bonus % of Salary	01-02 Total Compensation
President	\$170,000	\$70,000	41.18%	\$240,000
VP Legal	\$148,224	\$56,000	37.78%	\$204,224
VP Technology Solution	\$160,000	\$0	0.00%	\$160,000
VP Administration	\$158,594	\$60,000	37.83%	\$218,594
VP Default Management	\$113,578	\$23,000	20.25%	\$136,578
VP External Affairs	\$143,109	\$54,000	37.73%	\$197,109
VP Human Resources	\$124,384	\$23,000	18.49%	\$147,384
VP Loan Operations	\$137,102	\$52,000	37.93%	\$189,102
VP Client Services				
VP Public Affairs				

	02-03 Annual Salary	% Increase Annual Salary 01-02 to 02-03	02-03 Bonus	02-03 Bonus % of Salary	02-03 Total Compensation
President	\$185,000	8.82%	\$35,000	18.92%	\$220,000
VP Legal	\$160,000	7.94%	\$29,618	18.51%	\$189,618
VP Technology Solution	\$160,000	0.00%	\$11,323	7.08%	\$171,323
VP Administration	\$170,000	7.19%	\$31,690	18.64%	\$201,690
VP Default Management	\$118,121	4.00%			\$118,121
VP External Affairs	\$150,265	5.00%	\$28,596	19.03%	\$178,861
VP Human Resources	\$130,604	5.00%	\$24,855	19.03%	\$155,459
VP Loan Operations	\$143,958	5.00%	\$27,396	19.03%	\$171,354
VP Client Services					
VP Public Affairs					

	03-04 Annual Salary	% Increase Annual Salary 02-03 to 03-04
President	\$200,000	8.11%
VP Legal	\$160,000	0.00%
VP Technology Solution	\$160,000	0.00%
VP Administration	\$170,000	0.00%
VP Default Management	\$122,653	3.84%
VP External Affairs		
VP Human Resources	\$130,604	0.00%
VP Loan Operations	\$143,958	0.00%
VP Client Services	\$135,000	
VP Public Affairs	\$121,000	

We surveyed a range of public and private sector sources to determine best practices in establishing and administering a bonus plan in successful organizations.

Best practices in compensation policies and practices were reviewed from such sources as management consulting firms, professional accounting associations, policy think-tanks and human resource consulting organizations. These reveal several consistent themes.⁸⁸ To design a bonus strategy, organizations should:

- **Define a compensation philosophy.** A compensation philosophy must first answer the basic question: What does the organization want to reward? Bonus plans generally are established to reward achievement that exceeds expected performance and provide no payout for goals not achieved.
- **Link compensation to business strategy.** As a strategic plan is developed, compensation for top executives needs to be linked to the strategy. Clear indicators should be developed that define what the strategies mean in terms of the behavior of the organization.
- **Reward behaviors that drive results.** Value in an organization is driven by two actions: 1) doing the things customers want or need; and 2) doing them in a profitable and/or efficient manner. Both are needed to ensure survival and growth; one does not take precedent over the other, and therefore, cannot be “weighted” in importance.
- **Define, measure and track performance.** Performance should be measured in specific, objective, quantifiable measures that are understandable to both the organization and the general public. Emphasis should be placed on establishing accounting measures as much as possible.
- **Recognize the difference between results and effort.** Bonus plans are rewards to management and employees for results. If goals are not achieved, payouts do not occur. To the extent reward for effort is an element of a plan, a subjective element in the determination of the level of accomplishment is introduced. Thus, some recognition of effort may be made; however, it should be of less importance than the objective determinations.
- **Communicate constantly.** During the design and implementation of a bonus strategy, frequent communication is needed to keep everyone focused on outcome goals. While the determination of the level of achievement in meeting goals should be confirmed through an external audit process, there must also be periodic communication throughout the

⁸⁸ *Best Practices to Ensure Fair Compensation*, Chicago Area Partnerships (May 2003).
Company Bonus Plans Increasingly Take on a “Me Too” Approach, Towers Perrin (February 25, 2002).
Best Practices: Compensation, Chief Executives Working Together, TEOnline.
Use Best Practices in Executive Compensation Plan, American Institute of Certified Public Accountants (June 2002).

year. Monitoring and communicating levels of achievement or issues in meeting goals should be an ongoing process.

Findings

The current plan for awarding Executive Management Team bonuses is overly complicated and difficult to understand. The current methodology used to assess overall performance is extremely complicated and is made more so by the numbering system and the addition of the weighting formula introduced this year. In order to be most effective, bonus plans must be simple and understandable; they should clearly show how individual performance contributes to the success of the organization. A good example of a straightforward goal that is understandable to everyone both in and outside of the organization is the current *Goal 11: Cost per Loan Processed*. This goal identifies EDFUND's costs to process a loan – a metric that is understandable, easily tracked, and measurable.

The weighting and scoring process adds complexity rather than any real benefit. **Public Works** was provided with EDFUND's analysis of the overall performance of the organization, which included a description of the weighting system. We also reviewed a series of e-mails and memos in which CSAC raised issues about this analysis. EDFUND's bonus policy clearly indicates that the assessment of bonus opportunities for the EMT is based in great part on the assessment of overall agency performance. While no explicit reference is made to the Executive Team performance in the series of e-mails and memos, it is our understanding that this assessment of the organization would be an important element in determining executive level bonuses. In a memo to CSAC Chair David Roth, dated December 6, 2004, CSAC staff produced a thorough analysis of the problems with the current weighting and scoring system. CSAC's analysis indicates that the scoring and weighting system unnecessarily complicates the process and yields an uneven distribution of scores that will indicate success even if no goals are attained. That analysis identifies several major issues with the manner in which EDFUND calculated performance:

- The process for applying scores and weights requires significant value judgments made on the part of EDFUND. This process was not reviewed and approved by CSAC prior to use, nor can the measures be confirmed by an independent entity because of the subjective nature of the process.
- The weighting used allows for scores greater than 100, yet this is not figured into the calculation.
- The system understates the effect of the failure to meet goals. Thus, it seems possible to fail to achieve a number of goals and still receive bonuses.

EDFUND's development of and process for bonus planning provides for little up-front involvement from CSAC. The current plan provides for little or no assertive

planning of goals and objectives by CSAC. Neither the actual goals nor the process for determining levels of achievement are sufficiently defined in the Operating Agreement. Since the Executive Management Team bonuses are based primarily on an assessment of overall agency performance, the manner in which these measures are determined is critical.

While CSAC must provide EDFUND with the latitude to set goals for the year CSAC must understand and agree, not only to the goals, but also to the methodology that will be used to measure attainment. Participating more meaningfully in setting goals would strengthen CSAC's role as the oversight agency; clearly defining the methodology for assessing performance will ensure that decision-makers are in agreement when the process is implemented.

The yearly planning process does not include sufficient analysis when goals are not met – a tool that can be used to inform goal-setting for the following year. Goals not achieved may be an indication of poor performance, inflexibility of the organization to meet changing demands, incorrect identification of business drivers, or management's inability to adjust operations to meet demands. *Goal 3: Support Activity Efficiency* and *Goal 10: Cost Per Net Dollar Collected* were not achieved during FY 2003-2004, possibly indicating a failure to flexibly meet changing demands and resource reallocations. EDFUND indicates that support activity efficiency and cost per dollar collected were not achieved because of lower collection recovery rates. No explanation is provided to determine if attempts were made to adjust operations during the year to respond to lower collection recovery rates. A thorough analysis of the cause when performance goals are not met can become actions items to highlight issues for the next year's performance.

Recommendations

Improve the up-front planning process. Numerous communications between CSAC and EDFUND suggest that initial planning to establish the Executive Management Team bonus plan may not be adequate. A revised process should be developed to:

- Publish a statement of philosophy concerning the purpose and goals of the bonus plan;
- Establish goals and objectives that are transparent and understandable;
- Establish the mechanisms to track and measure goal attainment; and
- Revise the timetable for issuance of bonus plan decisions and payouts to account for needed changes in the process.

This transparency should be established before the start of the year and cannot change once established. Most importantly, the mechanisms to track and measure goal attainment should be agreed to prior to the start of the year so that measurement is understood, consistent and applied appropriately.

Simplify goals and objectives. EdFUND and CSAC jointly should develop goals that are simple, clear definitions of business success. These should be developed by operating unit so that they are easily related back to the organizational structure and are understandable to everyone both in and outside the organization. To the extent possible, goals should be accounting measures. At the very least, they should be carefully crafted and based on business objectives and an understanding of industry drivers.

Eliminate weighting and scoring of goals and objectives. The weighting and scoring procedures established by EdFUND complicate the process and do not add value to understanding the level of achievement. This process should be eliminated in favor of a straightforward determination of whether or not each objective has been met. Some less-quantifiable method to determine effort may be established, but it should be clearly defined, simple to understand, and calculated in a straightforward manner.

Establish mechanisms to report periodic assessments of level of achievement. The bonus plan should identify the critical factors that are to be monitored throughout the year. Once goals and objectives are established, the Executive Management Team should manage towards those goals and objectives, aligning operations to the goals. At the same time, this alignment can help focus communication on clearly defined critical factors. Periodic reporting against the goals and objectives should be established. This will contribute to everyone's understanding of the status of critical indicators, and there are no surprises when the independent auditor finalizes an assessment of goal achievement (see below).

Establish procedures to measure final determination of achievement through independent auditors. The majority of goals should be established as accounting measures in order to provide for the capability of independent auditors to assess the level of achievement through yearly auditing tasks. This will require an adjustment to the timetable for payouts to allow for the audit to be completed before determinations are made.

Include goals to address the CSAC and EdFUND relationship. CSAC should develop goals that address EdFUND reporting requirements. These should include the delivery of key reports, meetings, and any other process goal that would strengthen CSAC's ability to oversee EdFUND operations.

Link performance appraisals to the bonus plan. As part of the up-front clarification of the process for bonus planning, the link between performance appraisals and the bonus plan should be clearly stated for all Executive Management Team members, including the President. Establishing this procedure would allow CSAC and the EdFUND Board to ensure that an assessment of individual performance, as well as overall agency performance, is consistent with bonus payouts for each member.

Require a thorough analysis of goals not met to inform the planning process. Goals and objectives for the bonus plan should be established yearly. A

significant part of this process should be the analysis of reasons for goals not met. A thorough analysis of cause and effect can help improve the bonus planning process from year to year.

Executive Management Team: Skills and Experience

Scope of Review

Public Works was asked to review the process and metrics of the EdFUND Executive Management Team, including their skills and experience, and to assess their general preparedness for managing new diversified lines of business.

Methodology

We solicited and reviewed management team member resumes, examined position descriptions, and conducted personal interviews as part of this effort. We were asked to consider these past and current experiences in light of potential efforts to diversify EdFUND's business and reviewed documents and information regarding those efforts to date. Because of extremely limited direct contact with the members of the Executive Management Team, this portion of the review offers only general observations. We recognize the limits of assessing an individual's readiness for future work based upon a short interview and review of a resume and current job qualifications. Thus, this review should not substitute for the sort of rigorous due diligence that ought to be done prior to the engagement of business diversification activities – not only in vetting targeted lines of business or acquisitions, but also due diligence in undertaking a comprehensive assessment of EdFUND's and CSAC's preparedness for business diversification – by function, organizational structure, and personnel.

Business Diversification

Through the enactment of AB 2122, CSAC is authorized to allocate funding in order to expand its offerings in the student financial aid market through EdFUND. Although EdFUND is the second largest student loan guaranty agency in the nation, it had been authorized only to offer the core guaranty administrative services, unlike other leading guaranty agencies, some of which offer a variety of services related to student loans – including loan origination and disbursement services, private loans, and secondary market activities. As a result of AB 2122, CSAC and EdFUND have the go-ahead to offer some of the same financial aid products and services that their major competitors currently do.

The new authorization to diversify their business prohibits CSAC and EdFUND from entering into the issuance of bonds, loan origination or capitalization activities. However, CSAC and EdFUND may partner with other institutions that offer loan origination and capitalization, provided that the partnership provides operational and administrative services related to the Federal Family Education Loans that are:

- Related to student financial aid
- Consistent with the general mission of the Commission
- Consistent with the purposes of the federal Higher Education Act (which governs all U.S. student loan guaranty agencies)

EDFUND generates revenue based on its ability to avert loan defaults and to collect on loans that have defaulted. Under agreements with the U.S. Department of Education, EDFUND retains a share of the money generated by collections and receives incentive payments for preventing defaults. This money is deposited into a Student Loan Operating Fund. Since 1997, CSAC and EDFUND have channeled almost \$400 million from the Student Loan Operating Fund back into programs that directly benefit students, including financial aid outreach efforts; backfills to the General Fund that pay for Cal Grant awards and Cal Grant program administration; and a continuing policy of waiving the 1 percent loan guaranty fee. CSAC and EDFUND's ability to continue funding these programs is threatened by an increasingly competitive marketplace and the U.S. Department of Education's desire to renegotiate existing agreements.

Several of the position descriptions of EDFUND Executive Management Team members include duties that require efforts related to the diversification of EDFUND's business. For example, the President's position description states, "The President must devote herself to continuously building the Company's resources and opportunities to ensure that EDFUND can fulfill its mission of maximizing benefits to borrowers." The position descriptions for two Executive Management Team members are even more explicit. The position descriptions for the Legal Counsel and Chief Financial Officer require that they participate in "conducting due diligence, analysis and negotiation, deal structuring, and other activities associated with new business considerations by the organization."

Finally, CSAC and EDFUND are considering several options to generate new revenue so that they can continue funding direct student benefits in the future. Before actually beginning any business diversification activities, CSAC and EDFUND are required by law to present a detailed business plan to the Legislature for approval.

We reviewed outside studies (prepared by the Parthenon Group, a consultant retained by EDFUND to assist with business diversification-related studies), memoranda, and other documents that examine the need for business diversification and potential marketplace opportunities. EDFUND has devoted considerable effort to understanding the highly competitive student loan market and to examining what areas of the market other competitors have an advantage over EDFUND.

The closest approximation to a detailed business plan was a 10-page document, titled the "California Student Aid Commission and EDFUND Diversification Plan," dated May 2004. This document sets forward two promising business diversification proposals – an EDLOAN program, which would offer supplemental private loans to students who have exhausted their federal student loan eligibility, and an EdSOURCE

program, which would enable financial aid offices to outsource certain back-office functions to EDFUND. The discussion of the proposed EDLOAN program includes:

- Four summary paragraphs regarding the loan program's design.
- A brief discussion of program marketing -- the one aspect of the program that clearly could be undertaken in-house, building upon existing organizational structures, personnel, and strengths.
- One paragraph regarding origination and servicing of the private loans, noting simply that EDFUND has neither the resources or abilities to originate or service the loans and that it would have to develop partnerships with lender and loan services providers to implement this crucial portion of the program.
- Three paragraphs regarding the financial structure of the private loan program, including brief discussions of the need to establish an EDFUND Equity Fund to provide initial program capital and an operating subsidiary corporation.
- Two charts. The first chart compares the terms of a conservative model EDLOAN private loan vs. a typical private loan. The second offers a forecast of projected revenues, expenses, and other data associated with this program. This chart projects positive net income by the fourth year of the program's operation and \$39 million in total net income between now and the year 2018.

The discussion of the proposed EdSOURCE program includes:

- A five-paragraph description of the program's basic strategy.
- A four-paragraph description of how this program would be useful to current potential clients.
- One table projecting program revenues, expenses, and other data.

This plan then concludes with a one-page flowchart setting forth a potential timeline for business diversification. This timeline did not appear to factor in such pertinent issues as Department of Finance or legislative approval of the business diversification plan. The rationale underlying the key assumptions built into the program projections, such as how projected loan program take-up rates were determined, are not discussed. Nor are the many steps that would need to occur to bring the ideas to fruition discussed in any detail -- such as an action plan for identifying, vetting, and retaining partners to provide the loan origination and servicing that underlie the entire EDLOAN program.

This outline of a plan is a good start. Whether or not it constitutes a comprehensive plan depends upon what one considers comprehensive or a plan. It is certainly possible that a more comprehensive plan exists in much more robust form and we simply did not receive or review it.

General Findings

As a whole, the EdFUND Executive Management Team has a definite sense of its mission and the goals of the organization. The management team members' individual work experiences, as described in personal resumes and through individual interviews, generally meet the qualifications required by each person's position description. Assuming that steps are taken to address some of the concerns raised throughout this review, EdFUND's management team appears qualified and able to continue competing effectively in the highly competitive federal guaranty industry. In addition, the Executive Management Team seems poised to work with CSAC and the Administration to continue considering ways to diversify EdFUND's portfolio.

Given the limitations of the process used to review the Executive Management Team, we cannot conclude one way or another that the Executive Management Team, as currently comprised, possesses the kinds of skills needed to enable EdFUND to compete effectively against major competitors by managing and operating more diversified lines of business. The Executive Management Team may need to add individuals with subject matter expertise in potential new business areas, as much of the Team's experience seems to be concentrated on aspects of the management and operations of the FFEL Program. Similarly, CSAC and/or EdFUND may need to consider contracting out for assistance with the mechanics of undertaking due diligence, mergers, and/or acquisitions prior to any expansion into new lines of business beyond the FFEL Program, as only one member of the EdFUND Executive Management Team appears at first glance to have significant experience in those areas.

Finally, during the course of our interviews with staff, we observed that public affairs and communications is an area rife with organizational overlap between CSAC and EdFUND. This overlap is not in any way a negative reflection on any of the staff at either CSAC or EdFUND; in fact, we note that numerous collaborative efforts already are undertaken on joint publications, financial aid research, and the like. Nevertheless, direct contact with and outreach to federal and state governmental agencies could be carried out most effectively and efficiently through one voice, rather than separate operations. While there is ample rationale for maintaining some organization-specific communications and outreach functions, we encourage both organizations to explore potential opportunities for savings and the development of a more unified communications and outreach strategy through consolidation of CSAC and EdFUND's public affairs functions, particularly those impacting relations with governmental and media entities.

Oversight Recommendations

Many parts of the CSAC/EdFUND union seem to be working very well and collaboratively. For example, the human resource functions of both organizations seem to work well together and serve common needs and purposes. Similarly, within the information technology and communications areas, we observed a consistent pattern of joint projects and collaboration. Representatives of EdFUND and CSAC began meeting on a regular basis to address issues arising from the implementation of the Operating Agreement. And throughout this performance review process, numerous EdFUND and CSAC staff worked extremely diligently to answer questions, to gather information, and to respond to substantial requests under short timelines. They have our utmost respect and gratitude for their assistance and for recognizing that the ultimate purpose of this performance review is to assist both organizations in performing their work more effectively and efficiently.

Despite the foregoing – all of which is positive – the interactions between the two entities during the course of this performance review were problematic. To some extent, the depth of disagreement can be encapsulated by the disagreement that arose during preparation of this report as to whether or not the strained relationships we observed stemmed from the performance review process itself or predated and underlay those tensions – staff from one entity repeatedly told us that this is a constant state of affairs, while some staff from the other downplay or refute negative characterizations of the relationship between staff. We do not think that it requires much further explication to note that the parties cannot agree at almost every stage of interaction.

That the relationship problems between the two entities probably does in fact predate the performance review is evidenced by at least one point of contention between them: CSAC staff advised us, as noted earlier in this report, that they do not have access to EdFUND's financial system – a fundamentally basic oversight tool that government agencies often require as part of any vendor contract. EdFUND staff indicated that to their recollection, they have never been asked to allow CSAC access to EdFUND's system and would allow it if requested. CSAC staff claim that they have not specifically made this request, however, because of their sense of the futility of it. We do not know and cannot prove who is correct – nor is that our point. Our point is that there are tensions and communication difficulties in the CSAC/EdFUND relationship, and these do not appear to be productive for either agency or the public interest. Moreover, we assert not that these tensions and communications difficulties are the fault of any specific individuals, or one or the other entity, but result from an inherent structural tension that the Commissioners alone can address.

EdFUND's ability to continue to provide strong performance needs to be ensured, and as has been noted throughout this report, some areas of EdFUND's business call for

enhancement or further study. Implementation of our specific recommendations can help achieve those ends. We believe, however, that more general attention to the underlying structure of the relationship between CSAC and EdFUND could help cure many of the specific issues raised in this report and render some of our specific recommendations superfluous. It is therefore worth raising this basic structural issue as an alternative means further to enhance EdFUND's performance.

All parties assert that they agree that EdFUND is an auxiliary of CSAC. However, it is not clear what it means to be a public entity that functions as an "auxiliary" to another public entity but is also a private company. We have not found adequate explanation of this term and concept in the legislation or any other document provided to us, nor have we found agreement on its meaning. The parties have been challenged to work this out for themselves. Unfortunately, the answer involves a number of complex and, in some cases, competing public policies and objectives, the resolution of which is beyond the ability of well-meaning parties to disagree: EdFUND is a public entity, which raises issues of public oversight and accountability. On the other hand, EdFUND has been structured differently from other state agencies – specifically, CSAC – in order to allow it to function as a private business in its particular marketplace. By all accounts, EdFUND is quite successful in that capacity. A private company operates in different ways, and normally is not subject to the same sorts of accountability and oversight constraints as a governmental agency. Reasonable minds can differ as to the proper balance between the public policy objective of adequate oversight of EdFUND and the public policy objective of allowing EdFUND to function as it sees best in its private capacity.

A range of possible oversight relationships between CSAC and EdFUND is therefore conceivable, however, the authorizing legislation itself largely left this issue unresolved; instead, the statute requires EdFUND and CSAC to establish a working relationship in an annual "Operating Agreement." There has not been a meeting of the minds on a new "Operating Agreement" in several years, and the current "Operating Agreement," which sets forth the two organizations' roles and responsibilities for administering the Federal Family Education Loan Program and undertaking other related student aid work, was executed at the start of FY 2002-03. It is outdated in several respects.

The content and recommendations for modifying the Operating Agreement is the subject of more detailed discussion in the report being prepared by Market Value Planners. We raise the subject here, however, because some of the relationship aspects and points of friction between EdFUND and CSAC could be addressed more effectively in a revised Operating Agreement that is consistent with the owner-operator relationship that the Legislature appears to have intended when it authorized the creation of EdFUND. This would obviate the need to address individually many of the issues raised throughout this report, which ultimately owe their significance to the nature of the oversight of EdFUND by the CSAC Board. The Operating Agreement ought to reflect the danger of overly intrusive micro-managing of EdFUND by CSAC – micro-management that could disrupt operations and service delivery and lead to bad results

for the taxpaying “shareholders” of the organization – however, it also should give the oversight entity (CSAC) a clearer definition of its oversight authority, the goals and purposes of its oversight, and the means to effectuate it.

As the entity entrusted with the task of overseeing EdFUND, CSAC itself is ultimately responsible for the current state of affairs – and for rectifying any problems. We believe that there are a numbers of ways in which it can and should do so.

Recommendations

Enforce and strengthen existing controls and accountability. CSAC and EdFUND’s authorizing statutes provide ample room to establish and delineate clearly understood roles and responsibilities between the two organizations. CSAC, through its Commissioners and in consultation with staff, should determine the appropriate level of oversight and accountability to manage the operation of financial aid guaranty services effectively. CSAC also could set forth clearly what the penalties for the auxiliary’s failure to adhere to those roles and responsibilities would be, up to and including terminating the Operating Agreement and competitively bidding out the management of operating California’s guaranty services to another entity that can adhere to those roles and responsibilities.

Streamline oversight. Under the authority of the authorizing legislation, CSAC has delegated some key oversight responsibilities to the EdFUND Board or EdFUND staff. For example, through its top-down budget process, EdFUND staff proposes the organization’s initial budget level, a starting point that drives all subsequent budget calculations, projections, and funding levels leading to the approval of a final budget. Thus, without any discussions or meaningful input into the budget starting point, the CSAC Board effectively has limited its influence over the entire budget end product. Similarly, the EdFUND Board, as the entity’s directors, decides who receives the assessment survey of the EdFUND President’s performance, and the CSAC Board has little input into that evaluation. The compensation of the EdFUND Executive Management Team also is determined by the EdFUND Board. These are just a few examples of the ways in which bifurcation of responsibility for EdFUND has resulted in limiting the CSAC Board’s opportunities for more meaningful input to or oversight of EdFUND.

To remedy this potential problem – and thus virtually every other issue raised in this report – **CSAC could dissolve the current EdFUND Board of Directors and appoint its commissioners to serve in a dual capacity as members of the EdFUND Board.** We were asked to look at duplication in many areas of operation, and one area of duplication and overlap is the existence of two separate boards. CSAC’s Commissioners ought to take more direct responsibility for EdFUND. This would encourage the CSAC Board to take a more active role in the oversight of its auxiliary, which hopefully would lead to more accountability, more organizational transparency, better joint planning by both organizations, decreased duplication of board-level activity, and increased efficiency. We understand that there are also objections to such an

approach, and that it has been previously examined and rejected by the Bureau of State Audits and the Commission itself. We believe that it is worth re-examining to weigh the degrees of independence that CSAC's auxiliary should have with the auxiliary's responsiveness to its owner. If this recommendation is pursued, CSAC will need to determine the auxiliary's lines of reporting *vis-a-vis* CSAC staff in light of the degree to which it wishes to shift oversight workload directly to the Commissioners and to put the auxiliary on equal footing with the CSAC staff.

There is, of course, an alternative: EdFUND could be turned into a fully private company. This can be effectuated by EdFUND repaying back its initial revolving funds from the State and then competing in the marketplace for its current guaranty business, just like any other private company. This approach was championed by the California Performance Review. We doubt, however, that EdFUND, CSAC, or the State Legislature desire such a result – and there are certainly public policy arguments against it.

It is therefore even more important that the nature of the relationship between a public agency and its “auxiliary,” structured as a company, be better defined; in fact, if that were so, we believe that the other issues we raise in this report could be much more easily addressed and resolved.
