

**California Department of Toxic
Substances Control**

Preliminary Assessment of the Accounting
System, Policies and Procedures, Internal
Controls, and Records as It Relates to the
Exide Program

FINAL REPORT



Certified
Public
Accountants



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Public
Accountants

October 2, 2017

Ms. Barbara A. Lee, Director
Department of Toxic Substances Control
Environmental Protection Agency, State of California
1001 I Street
Sacramento, CA
95812

Dear Ms. Lee:

We are pleased to present the results of our preliminary assessment of the Department of Toxic Substances Control's (DTSC) accounting system, policies and procedures, internal controls, and records as it relates to DTSC's Exide Program. Our assessment also included testing of all relevant program expenditures incurred during the Fiscal Year (FY) 2015/2016 and the first and second quarters of FY 2016/2017.

Sincerely,

A handwritten signature in black ink that reads "Macias Gini & O'Connell LLP". The signature is written in a cursive, flowing style.

Macias Gini & O'Connell LLP

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EXECUTIVE SUMMARY

BACKGROUND

The California Legislature required the California Department of Toxic Substances Control (DTSC) within the California Environmental Protection Agency, to have general administrative responsibility for overseeing the State's response to spills or releases of hazardous substances, and for hazardous waste disposal. Existing law establishes the Toxic Substances Control Account in the General Fund and authorizes moneys in the account, upon appropriation, to be used for, among other purposes, the payment of all costs of removal and remedial action incurred by the state in response to a release of a hazardous substance. Assembly Bill (AB) 118 appropriated \$176.6 million from the account to DTSC for activities related to the cleanup and investigation of lead-contaminated properties in the communities surrounding the Exide Technologies facility in the City of Vernon.

DTSC manages the cleanup program, which includes sampling up to 10,000 residential yards, schools, daycare centers, and parks in the 1.7-mile radius of the former Exide plant and cleaning up the areas with the highest levels of lead and risk of exposure. DTSC also established an Advisory Group of community leaders, local residents, business leaders, scientists, and elected officials to help guide closure and cleanup efforts.

WHY WE CONDUCTED THIS PERFORMANCE AUDIT

In an effort to promote transparency and ensure the fiscal integrity of the funds authorized by AB 118, DTSC engaged Macias Gini & O'Connell LLP (MGO) to provide technical assessment, consultation, and support on work related to DTSC's accounting, budgeting, expenditures, and cost recovery preparation for the Exide Program. MGO's contract with DTSC requires a series of reports covering Fiscal Years (FY) 2015/2016, 2016/2017, and 2017/2018. This report, the first in the series, provides a preliminary assessment of DTSC's accounting system, policies and procedures, internal controls, and records as it relates to the Exide Program. Our assessment included testing of Exide Program expenditures incurred during FY 2015/2016 and the first and second quarters of FY 2016/2017.

WHAT WE FOUND

DTSC maintains a strong system of internal controls as measured against the control components of the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) integrated framework. This includes the critical business processes needed to accurately account for and report Exide expenditures (such as budgeting, contracting, accounts payable, and timekeeping). Our detailed testing of Exide expenditures, both for goods and services, and direct and limited-term labor, found no deviations from established DTSC program policies and procedures.

PERFORMANCE AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY

PERFORMANCE AUDIT OBJECTIVES

For the purposes of the preliminary assessment, our objectives were to:

- (1) Determine the adequacy of internal controls of DTSC's Exide accounting system and records, at the program and administrative accounting level, including the system(s) ability to record, process, summarize, and report financial information, including budgeting and cost recovery. This included an evaluation of the accounting and budget policies and procedures using the internal control framework provided by COSO¹, as criteria².

- (2) Determine through detailed testing that expenditures were:
 - recorded in accordance with generally accepted accounting principles (GAAP) for government,
 - in agreement with both original documents and financial system input,
 - eligible for inclusion in the Exide Program,
 - sufficiently documented to support future cost recovery.

SCOPE

The scope of this initial assessment was limited to DTSC's administrative policies and procedures for managing the accounting of expenditures related to the Exide Program (as authorized by AB116) incurred during FY 2015/2016 and the first two quarters of FY 2016/2017.

METHODOLOGY

To assess and evaluate the overall control environment, which includes the accounting and budgeting policies and procedures, among other features in place to ensure appropriate internal control, we conducted interviews with managers and supervisors to understand the workflow process and important control points in four critical areas and compared them to policies and procedures, as well as leading practices:

- Budgeting
- Contracting
- Accounts Payable
- Timekeeping

¹ The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, the Association of Accountants and Financial Professionals in Business, and the Institute of Internal Auditors. COSO is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

² Internal Control – Integrated Framework Committee of Sponsoring Organizations, May 2013. Available at www.coso.org

We tested expenditures incurred in FY 2015/2016 and in the first two quarters of FY 2016/2017. The testing included purchases of goods and services and direct time of regular state employees who support the Exide Program and other Exide labor classified as “limited-term.”

In reviewing invoices for goods and services, we tested to verify that:

- Amounts on 20 invoices agreed with amounts recorded in the financial system for accuracy, description, and activity code.
- Invoices were clearly coded to the Exide Program, certified, and signed off by a manager.
- Invoices were processed using standard payable controls and were fully paid.

We judgmentally sampled 25 time sheets from each of two work categories—regular full-time employees and limited-term employees, those with work contracts extending only through the duration of the Exide project. While the number of limited-term employees was fewer in number as compared to the regular employees, we decided to draw similar sample sizes because we judged the risk of error greater in this category. In reviewing time charges, we obtained a sample of time sheets and tested to verify whether:

- Employees were charging to valid Exide activity codes.
- Time charges agreed to hours recorded in the financial system.
- A supervisor or manager signed and dated each timesheet.

To assess the reliability of the data related to the expenditures in Fi\$cal for goods and services and time charges of DTSC’s Exide Program, we reviewed existing documentation related to the data sources and discussed with program staff about the data. We tested 93 percent of the goods and services expenditures by tracing the information in Fi\$cal to the source documents and noted no exceptions. We also tested the time charges of 60 time sheets (30 permanent staff and 30 limited-term staff) to the original time sheets and noted no exceptions. We determined that the data were sufficiently reliable for the purposes of this report.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

PRINCIPAL RESULTS

This performance audit report is the first in a series of reports designed to provide periodic updates on the progress of expending the funds obligated by the State in support of the Exide clean-up efforts. This first report covers two areas: (1) a preliminary assessment of the adequacy of internal controls over DTSC’s Exide accounting, budgetary, and contracting processes and (2) a review of expenditures to ensure DTSC has accurately recorded, supported, summarized, and reported the results of such spending.

PRELIMINARY ASSESSMENT FINDS STRONG CONTROL STRUCTURE

Based on the definition and description contained in Internal Control – Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) the definition of internal reads as follows:

A process effected by those charged with governance, management, and other personnel that is designed to provide reasonable assurance about the achievement of the entity’s objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over safeguarding of assets against unauthorized acquisition, use or disposition may include controls relating to financial reporting and operations objectives.

Internal control is comprised of five components that work together in an integrated framework:

- Control Environment;
- Risk Assessment;
- Control Activities;
- Information and Communication; and
- Monitoring Activities.

The objectives of the five components are defined in Figure 1.0 along with examples of methods that may be used by government agencies to address each component. While all components are important, the emphasis of our assessment centered on Control Activities. We found the DTSC’s controls are strong and generally follow the COSO framework, as described below.

Figure 1.0: COSO Internal Control Components and Associated DTSC Activities (Highlights)

COSO Component	DTSC Activities and Results of Performance Audit
1. <i>Control Environment.</i> Management and employees should establish and maintain an environment that sets a positive and supportive attitude toward internal control and conscientious management (e.g., appropriate training, ongoing supervision).	We found that DTSC maintains a strong organizational structure, supported by defined policies and procedures that align with State systems such as Fi\$Cal and State contracting practices, and include an emphasis on internal control.

<p>2. <i>Risk Assessment.</i> Internal control should provide for an assessment of the risks DTSC faces from both external and internal sources that may impair, hinder, or prevent DTSC from achieving its objectives including those related to its financial accounting and reporting.</p>	<p>Although DTSC has a non-integrated informal risk assessment process over expenditures of Exide funds, we found DTSC's role in providing independent oversight and responsibilities is specifically designed to address external and internal risks over Exide related expenditures to ensure that financial information is accurate, timely, and in accordance with State policy. One such risk is cost overruns in cleanup contracts, which DTSC mitigated by only entering into "Not-to-Exceed" contracts with major contractors.</p>
<p>3. <i>Control Activities.</i> Internal control activities (e.g., approvals, verifications, documentation) should be effective and efficient in accomplishing an agency's control objectives.</p>	<p>We tested and verified that the DTSC policies and procedures include control activities to ensure that processes work as intended. Testing included walk-throughs and document reviews of contracting, accounting, to include timekeeping and accounts payable and budgeting processes.</p>
<p>4. <i>Information & Communication.</i> Information should be recorded and communicated to management and others within the department who need it, and in a form and within a timeframe that enables them to carry out their internal control and other responsibilities.</p>	<p>We found that DTSC communicates information about Exide spending on a consistent and periodic basis to the Exide management and staff. This includes:</p> <ul style="list-style-type: none"> • Periodic updates of budgetary progress • Quarterly expenditure reporting • Contract updates and amendments • Availability/distribution of formal policies and practices, • Memos regarding accounting and documentation requirements for the Exide project, and • Communications from the field, e.g. monthly or weekly field updates.
<p>5. <i>Monitoring.</i> Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.</p>	<p>Monitoring in the DTSC's Exide administrative processes mainly takes the form of supervisory activities:</p> <ul style="list-style-type: none"> • The Fiscal Officer reviews Exide expenditures on a monthly basis. • Contracts unit reviews contract-specific Exide expenditures monthly. • Exide program managers collect data weekly on all expenditures as compared to projected project expenditures.

Source: Internal Control Integrated Framework, 2013, published by COSO

Reviews of process workflows in four important functions found strong controls are consistently present

We conducted interviews with staff and examined documents to understand the workflow process and important control points in four critical areas. We compared them to policies and procedures, as well as leading practices. These areas included budgeting, contracting, accounts payable, and timekeeping.

Budgeting Exide Costs Follows Established Guidance

We found the Exide budgeting process works as intended. Our audit covered \$1,729,675 of the program's total expenditures expended through the audit period, between FY 2015/2016 and the first two quarters of FY 2016/2017. We also noted that budget and expenditure codes created for Exide were used consistently on timesheets and invoices.

The budget process for the Exide program is a straightforward process. Exide funds were appropriated to cover the program’s three- fiscal year term. Budgeted funds that are either under- or over-estimated each year are carried forward to the next year without legislative approval. An annual budget plan is prepared and updated each quarter with actual expenditures, and distributed to Exide staff. The budget staff calculates forecasted expenditures in collaboration with the Exide program office based on an analysis of the approximate number of sites expected to be surveyed and cleaned up in future periods.

We obtained both the annual budget projections and actual expenditures for FY 2015/2016. A budget was established for the purchase of goods and services; however, no spending occurred in FY 2015/16. The budgeted funds were carried over to FY 2016/2017. In addition, some salary expenses occurred in the last quarter of FY 2015/2016.

We also obtained the annual budget forecast for FY 2016/2017, as well as the quarterly expenditure updates for the 1st and 2nd quarters of FY 2016/2017. We used these reports to guide the expenditure testing. To track Exide project expenditures, the budget staff established the following reporting structure in the Fiscal Information System for California (Fi\$Cal), as shown in Figure 2.0:

Figure 2.0: Exide Project ID and Activity Codes

Project ID	Fund	Activity Codes
DTSCNEWEXIDE	0557	7001, 7002, 7003, 7004, 7006

We noted while reviewing and testing transactions that all invoices and time charges were coded to the project identification code DTSCNEWEXIDE and to Exide activity codes. We noted no discrepancies in the use of these project and activity codes.

Contracting Practices Follow Established Guidance

Contracting is an essential part of the Exide Program, especially in the early stages when large contracts were negotiated with major clean-up contractors. Our review of this area focused on whether DTSC carried out its contracting responsibilities in accordance with long-established DTSC contracting guidance, which covers the steps needed to organize and manage the competition process culminating in the selection of winning vendors.

The DTSC Contracting unit has an established contracting process outlined in the DTSC Contracting Handbook (last updated in 2017). This guidance mirrors the State Contracting Manual, which provides policies, procedures, and guidelines to promote sound business decisions and practices in securing necessary services for the State. Most DTSC contracts are exempt from review by the Department of General Services (DGS); however, due to the sensitivity of the Exide program, DTSC decided to have all Exide-related contracts negotiated in-house sent to DGS for further review.

We reviewed two current Exide contracts to confirm that the contracting process explained in the guidance was followed and found no discrepancies. For each contract selected, we reviewed the electronic or paper contract file to determine if all steps in the process were documented and included in the file. Each contract file contained a “tracking log” which indicates the date when each step (i.e., date the draft of the contract was completed by the draft analyst, date the vendor reviewed and provided comments on the draft of the contract, etc.) in the contract process was completed. Additionally, each file contained the contract, important documents in the process, and a “Standard Form 215,” which contains information regarding the value of the contract. The following contract files were reviewed:

- Contract File 16-T4161 – This contract was awarded based on DTSC submitting an Invitation for Bid (IFB) posted on the Cal eProcure public website. The IFB contained the scope of work, proposal requirements, key action dates for the contract, and how the winning contract was

determined. Four proposals were submitted for this contract. DTSC determined the winning vendor based on a pass/fail scoring system conducted by a selection panel. Once the contract unit staff determined the winning vendor, a letter was sent to all the vendors who submitted a proposal notifying that a vendor had been awarded a contract for the respective IFB. A fully executed contract was prepared and signed by DGS.

- Contract File 16-T4186 – This contract was awarded to the most qualified vendor based on pre-established qualifications. Every three years, DTSC sends out a Request for Qualifications (RFQ) to Architectural and Engineering (A-E) firms who believe they meet the qualifications and needs of DTSC. DTSC reviews the contractor’s qualifications and conducts a proposer interview for contractors who meet their qualification standards. DTSC ranks the contractors on the A-E short list for the upcoming three years. When DTSC has a need for a project to be completed, DTSC will ask the contractors on the short list if they are interested in the project based on the scope of work and if so, a cost negotiation will take place. The paper file for this contract included documents confirming this A-E vendor selection.

Accounts Payable Testing Confirmed Strong Processing Controls

A critical control over expenditures is the review and approval process prior to payments to vendors. Accounts Payable staff must ensure that payments are made only after there is ample evidence of receipt of goods and/or services and approval by cognizant managers is verified. Payments must be fully documented to include the approved request for goods and services and the invoice from the vendor. Once these criteria are met, a request for payment can be processed.

We conducted a walk-through of the Accounts Payable section, where all invoices related to the purchase of goods and services are processed. Invoices must indicate that the goods and services have been received and performed in an acceptable manner, as indicated by a signed and dated approval by authorized staff knowledgeable about the goods and services received. Invoices related to contracts are first sent to the contracts unit, reviewed, approved, and passed on to the Accounts Payable unit who processes the invoice by entering the data (Exide project ID and activity codes) into Fi\$Cal. Invoices not related to contracts are sent directly to Accounts Payable for the same process. Most payments are made by warrant prepared by the State Controller’s Office; however, DTSC is authorized to issue checks in cases where expedited payments, such as employee travel, are necessary.

After verifying the basic process controls in place by reviewing forms and documents during the walk-through, we validated process controls of reviews and approvals through invoice testing. We tested 20 invoices, or 93 percent of payments made for goods and services incurred in the first two quarters of FY 2016/2017 and found no exceptions, as shown below in Figure 3.0.

Figure 3.0: Invoice Testing—Exide Goods and Services

Type of Expense	Amount Incurred in FY15/16	Amount Tested	Exceptions Noted	Amount Incurred FY 16/17 1 st & 2 nd Qtrs.	Amount Tested	% Tested	Exceptions Noted
Goods/Services Invoices	\$0	N/A	N/A	\$458,419	\$428,263	93	0

Timekeeping Controls Generally Strong

DTSC regulations require staff to report time on a Daily Log Timekeeping System. The Daily Log allows each employee to account for each workday by activity code. The timekeeping system contains both the Daily Log and the monthly Employee Time Sheet. Monthly time sheets show summarized totals for project activity codes. Only the Daily Logs break out the time by individual workdays. A supervisor must sign and date each time sheet to verify the accuracy of the time charges. While the system contains many controls, one weakness is that any DTSC employee can charge time to Exide activity codes even though they may have no connection with the program. It is up to supervisors to ensure that the staff time charged to the Exide program is accurate and appropriate. The section manager stated that an expected system upgrade should include a control to prevent time charges by employees not assigned to the Exide program.

Our testing of 60 time sheets did not reveal any erroneous time charges to Exide activity codes for sheets sheet permanent and -term employees. These are shown in Figure 4.0 below.

Figure 4.0: Time Charge Testing-Permanent and Limited Term Staff

Type of Expense	Hours Charged in FY 15/16	Hours Tested	%	Exceptions Noted	Hours Charged in FY 16/17 1 st & 2 nd Qtrs.	Hours Tested	%	Exceptions Noted
Permanent staff time sheets	1,825	742	41	0	20,950	1,239.5	5.9	0
Limited-Term staff time sheets	0	N/A	N/A	N/A	9,537	3,088.0	32.4	0

EXPENDITURE REVIEW RESULTS

We tested expenditures for goods, services, and DTSC payroll to verify (1) adherence to generally accepted accounting principles for government (GAAP) promulgated by the Governmental Accounting Standards Board (GASB), (2) agreement between original source documentation and financial system records, (3) evidence that the expenditures are eligible to be part of the Exide Program, and (4) sufficient support and justification to support cost recovery.³

While a capable and functioning financial accounting and reporting information system may be used for cost accounting or cost recovery, it requires manual, automated, or a combination manual and automated processes to ensure either cost accumulation or cost finding. This performance audit, the first in a series, evaluates DTSC and the Exide program's financial accounting and reporting accountability. Subsequent audits and their related reports will evaluate DTSC and the Exide program's capability to support cost recovery.

GASB establishes accounting and financial reporting standards for state and local governments. These basic rules of GAAP are used to produce internal and external financial reports for making economic, social, and political decisions, as well as assessing accountability by comparing actual financial results with adopted budgets, helping determine compliance with finance related laws, and assessing the results of operations. The usefulness of accounting information for decision-making requires timely transaction recording, and that recorded transactions are verifiable, unbiased, representationally faithful to the underlying event or transaction, relevant, and comparable.

³ Revenues, revenue recoveries, transfers, classification of fund balance, and organization lines of responsibility and authority were not evaluated. Furthermore, GASB's authority does not extend to cost accounting or cost recovery.

We found DTSC's budgeting and accounting practices are consistent with GASB standards for expenditure classification. We evaluated Exide program expenditures for compliance with GASB standards, which require that expenditures should be classified by fund, program, organization unit, activity, character, and object. A fund is the basic fiscal and accounting entity to establish accountability. Classification by program allows for the grouping of activities directed to the accomplishment of a major service or regulatory responsibility. Management control is provided through the classification of expenditures by organization unit that fixes responsibility at a department level, whereas a number of departments may be responsible for a program. Activity classification allows the tracking and accountability of a specific and distinguishable line of work performed by an organization. Current expenditures, capital outlays and debt services are common expenditure classifications that identify the period (fiscal year) benefitting from the expenditure. Finally, classification by object of expenditure generally provides a greater level of detail on the items or services purchased.

Expenditures Adhere to GAAP

According to the basic rules of GAAP, transactions should be recorded, verifiable, relevant, and comparable. Our goal in auditing Exide expenditure transactions was to ensure transactions were processed in a manner that meets GAAP's basic tenets, and that the processes and controls were applied consistently. There are two types of expenditures that make up the DTSC Program: (1) invoiced amounts representing charges for either goods or services, and (2) direct labor time charges for regular and limited-term Exide staff. For each expenditure tested, we determined adherence to GAAP by ensuring each transaction was (1) accurately recorded in the database, (2) verified by a manager or authorized individual, (3) relevant to the Exide program, and (4) comparable to the other transactions in that they were processed and supported in a similar manner. We selected the following transactions for detailed testing and found no deviations from GAAP:

- Invoice testing for goods and services included comparing the amounts shown in budget and expenditure reports prepared by the budget unit. There were no purchases for goods and services in FY 2015/2016. In the first two quarters of FY 2016/2017, Exide expenditures for goods and services totaled \$458,419, of which we tested 20 invoices amounting to \$428,263, using the testing attributes shown in Figure 3.0.
- We sampled time charges (using monthly timesheets) for both regular and limited term⁴ staff. In FY 2015/2016, there were no time charges for limited term staff; and regular staff only charged time in May and June 2016, the last two months of the fiscal year. We tested to ensure that the charges were valid, followed established rules for approval, and were accurately coded as an Exide expenditure item. Attributes tested are shown in Figure 4.0.

Subsequent Audits will Assess Expenditure Detail Needed for Cost Recovery

Federal and State law authorizes DTSC to recover costs and expenses it incurs in carrying out Exide program activities. Our preliminary review found that all expenditures were controlled and adequately documented. In subsequent audits, we will assess the adequacy of expenditure tracking and supporting documentation of expenditures to ensure cost recovery.

⁴ We tested limited-term staff timesheets using the same criteria as applied to regular DTSC staff time sheets.

CONCLUSIONS

DTSC maintains a strong system of internal controls as measured against the control elements of the COSO framework. This includes the critical business processes needed to accurately account for and report Exide expenditures, such as budgeting, contracting, accounts payables, and timekeeping.

RECOMMENDATIONS

As described in our results and conclusions, we found no areas requiring corrective actions; therefore, we make no recommendations.

DTSC COMMENTS

DTSC reviewed the draft report but did not provide formal comments for inclusion in the final report.