

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**STATE OF CALIFORNIA
FINANCIAL AND COMPLIANCE
SINGLE AUDIT REPORT
YEAR ENDED JUNE 30, 1985**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

F-581

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APRIL 1986



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April 8, 1986

F-581

Honorable George Deukmejian
Governor, State of California
State Capitol
Sacramento, California 95814

Dear Governor Deukmejian:

The Office of the Auditor General presents its Financial and Compliance Single Audit Report for the State of California for the year ended June 30, 1985. We conducted the financial and compliance audit in accordance with both generally accepted auditing standards and generally accepted government auditing standards. This report fully meets the audit requirements set forth by the United States Government as a condition of receiving over \$10 billion in federal funds annually.

Our report is divided into two parts. Part I discusses weaknesses in the State of California's control of its financial operations. We noted the weaknesses during our review and evaluation of the State's internal accounting controls, internal audit activities, and compliance with federal grant requirements. We made this review as part of our examination of the State's General Purpose Financial Statements. Part II is the State of California's financial report for the year ended June 30, 1985. We originally issued this report in March 1986.

Although we have previously reported on many of the financial and administrative problems disclosed in this report, the state agencies we reviewed have not always taken corrective action. The State continues to lose millions of dollars each year because agencies do not adequately pursue amounts owed to the State, do not control appropriations and expenditures, and do not maintain sufficient equipment records. Also, the State's audit costs are higher than they need to be because the Office of the Auditor General can not always rely on work of the internal auditors. In addition, the state agencies' inability to produce financial statements on time continues to be a problem.

Sincerely,


THOMAS W. HAYES
Auditor General

TABLE OF CONTENTS

	<u>Part</u>
REPORT ON THE EVALUATION OF INTERNAL CONTROLS AND THE REVIEW OF COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS	I
STATE OF CALIFORNIA FINANCIAL REPORT YEAR ENDED JUNE 30, 1985	II

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	i
INTRODUCTION	1
AUDIT RESULTS	
I WEAKNESSES IN FINANCIAL OPERATIONS	5
II WEAKNESSES IN ELECTRONIC DATA PROCESSING ACTIVITIES	23
III VARIANCES FROM INTERNAL AUDIT STANDARDS	27
IV WEAKNESSES IN COMPLIANCE WITH STATE REGULATIONS	31
V WEAKNESSES IN COMPLIANCE WITH FEDERAL REGULATIONS	37
VI CONCLUSION AND RECOMMENDATIONS	43
REPORT ON THE STUDY AND EVALUATION OF INTERNAL CONTROL	45
WEAKNESSES IN INTERNAL CONTROL DISTRIBUTION BY STATE AGENCY	51
DETAILED DESCRIPTION OF WEAKNESSES BY STATE AGENCY	63
REPORT ON COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS	209
SCHEDULE OF FEDERAL ASSISTANCE FOR THE FISCAL YEAR ENDED JUNE 30, 1985	215

TABLE OF CONTENTS (Continued)

	<u>Page</u>
APPENDICES	
A REPORTS ISSUED BY THE OFFICE OF THE AUDITOR GENERAL JULY 1, 1984 THROUGH DECEMBER 31, 1985	245
B SCHEDULE OF AUDIT REPORTS INVOLVING FEDERAL GRANTS JULY 1, 1984 TO DECEMBER 31, 1985	251
RESPONSE TO THE AUDITOR GENERAL'S REPORT	
Department of Finance	257

PART I

**REPORT ON THE EVALUATION OF
INTERNAL CONTROLS AND THE REVIEW OF
COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS**

SUMMARY

The State of California has taken some action to improve its financial controls and accountability in recent years. Nevertheless, the State must place greater emphasis on and allocate a larger portion of available resources toward improving its accounting, auditing, financial, and administrative control systems. These systems are the key to ensuring that all state funds are accounted for properly, that budgets are not exceeded, that cash and other assets are protected from loss or theft, and that accurate financial information is available to the Governor and the Legislature for budgetary decisions. Breakdowns in these control systems continue to increase state costs or limit the State's effectiveness in areas such as managing state contracts with private sector firms, approving loans to California veterans, and monitoring spending by local school districts.

While the State of California corrected some of the individual weaknesses in internal controls that we reported last year, the State lost at least \$2 million in foregone interest and discounts, and it will not be able to collect over \$1 million of accounts receivable because of internal control weaknesses that we have reported each year since 1983. Furthermore, based on reports that the Auditor General issued from July 1, 1984, through December 31, 1985, we estimate that the State could have earned an additional \$8 million in interest and other types of revenue, that it spent \$58 million for non-functional items, and that it risks losing \$3 million in accounts receivable. These losses and potential losses have occurred because the State's overall fiscal control system did not measurably improve during this 18-month period. These losses are based on samples of the State's financial transactions and are not intended to illustrate all of the State's losses due to weaknesses in financial controls.

During our audit of the State's financial statements for fiscal year 1984-85, we found that 22 of the 32 agencies in which we performed in-depth reviews had weaknesses in the internal controls that apply to financial operations, electronic data processing, internal audits, or compliance with federal regulations governing the State's administration of federal grants. These 32 agencies account for approximately 80 percent of the State's spending. Although the opportunity to recover past losses is limited, executive agencies can prevent losses in the future by improving their internal controls. The Auditor General has made specific recommendations to help the various executive agencies make such improvements.

Financial Operations

The State's ability to produce financial statements on time continues to be a problem. Major private sector firms like IBM, General Motors, and Hewlett Packard must produce audited financial statements within 90 days after the close of their fiscal year. The State of California, on the other hand, has six months to produce audited financial statements. Nevertheless, as of February 14, 1986, nearly eight months after the end of the fiscal year, the State has been unable to produce even unaudited financial statements. As a result of this delay, the State will be unable to issue audited financial statements before March 1986, approximately nine months after the end of the 1984-85 fiscal year. One of the major causes of this delay is the late submission of financial reports by many state agencies. Of the 294 agencies that are required to submit year-end financial reports to the State Controller, 176 agencies submitted their final reports late. This lack of fiscal accountability and discipline contributes to the financial control breakdowns and losses of state funds that occur each year.

We noted weaknesses in 16 of the state agencies whose financial operations we reviewed in detail. These 16 agencies account for approximately 75 percent of the State's spending. Fourteen

agencies had deficiencies in reporting practices. These deficiencies include improperly recording transactions in the accounting records and inadequately preparing various reconciliations and year-end financial reports. As a result of these deficiencies, some agencies' financial reports were neither complete nor accurate.

Nine agencies did not adequately control the collection of revenues. Six agencies did not promptly bill for goods or services rendered or were slow in collecting money owed the State. Two agencies did not promptly deposit collections. As a result, we estimate that at least \$1.3 million of the State's potential revenues are now uncollectible, and the State lost potential interest earnings of at least \$1.5 million.

Fifteen agencies had weaknesses in controlling expenditures. As a result of the poor payment procedures in many of these agencies, two agencies spent \$11 million more than the State had authorized, the State lost approximately \$10,000 in foregone vendor discounts, and some employees were not paid appropriately. In addition, employees were allowed to terminate employment before returning state property and repaying outstanding advances.

The State cannot identify all of the assets that it owns because it continues to exercise poor accounting control over billions of dollars in fixed assets, including machinery, office equipment, and computers. For this reason, the State is exposed to an increased risk of loss of assets and cannot accurately report on general fixed assets in its financial statements.

Finally, in maintaining its accounting records, the State does not fully comply with generally accepted accounting principles, which are recognized throughout the nation. As a consequence, the State Controller must continue to spend state time and money to convert the State's financial reports so that they comply with these principles and

are comparable to those of other governmental entities and, therefore, are understandable and acceptable to the investment community. Although the State has made some progress in gaining a greater degree of compliance with generally accepted accounting principles, it should continue to move toward full compliance.

Electronic Data Processing Activities

We reviewed electronic data processing (EDP) activities in 13 state agencies; 8 of these agencies did not properly control their EDP activities. Failure to control EDP activities can result in unauthorized changes to computer programs and files and the processing of improper distribution of state funds. Agencies did not adequately separate incompatible duties, did not maintain good systems and program documentation to control program changes, and did not properly control access to hardware, files, and documentation.

Internal Audit Activities

Six of the 13 internal audit units we reviewed did not completely comply with the professional standards established by the Institute of Internal Auditors, Inc. California Government Code Section 1236 requires state agencies having internal audit units to adhere to these standards. The standards embody the goals of internal auditing pertaining to independence, professional proficiency, scope of work to be performed, conduct in the performance of audit work, and management of internal auditing departments.

When internal audit units fail to comply with professional standards, external auditors may be precluded from relying on the work that the internal auditors perform. Because the Auditor General could not always rely on the work of internal auditors, the State's audit costs are higher than they need to be.

Compliance With State Regulations

In three areas, agencies did not comply with state regulations that help the State maintain adequate control over budgeting, collecting, and disbursing state monies. We noted weaknesses in purchasing, school apportionments, and agency audits of service providers and educational agencies.

Compliance With Federal Regulations

In numerous instances, state agencies were not complying with federal requirements for administering federal grants. As a condition of continued federal funding, the State must adhere to certain federal regulations in disbursing the grant funds. Compliance requirements typically address recipient eligibility, reimbursable costs, program monitoring, and reporting.

The State did not fully comply with at least one federal regulation in 31 of the more than 34 grants that we reviewed. As a result, the federal government could penalize the State for not fully complying with the grant requirements.

INTRODUCTION

As part of our examination of the General Purpose Financial Statements of the State of California for the fiscal year ended June 30, 1985, we studied and evaluated the State's system of internal controls. The purpose of our study of the system of internal controls was to determine the audit procedures and the extent of testing necessary for (1) expressing an opinion on the State's General Purpose Financial Statements, and (2) determining compliance with federal grant requirements, laws, and regulations. In conducting our audit, we performed detailed reviews in 32 of the State's 294 agencies required to submit financial reports. In dollar volume, these 32 agencies account for approximately 80 percent of the State's spending. We also performed centralized testing that encompassed the operations of all of the State's agencies.

We reviewed the internal audit units of 13 state agencies for compliance with professional standards. We conducted two kinds of reviews of internal audit units: in-depth reviews and limited-scope reviews. In the in-depth review, we examined compliance with the "Standards for the Professional Practices of Internal Auditing" of the Institute of Internal Auditors, Inc. We selected five internal audit units for these in-depth reviews: the Franchise Tax Board's Internal Audit and Evaluation Bureau, the Department of Health Services' Internal Audit Section, the State Controller's Management Audits and Review Section, the Department of Transportation's Caltrans Audits

Office, and the Department of Water Resources' Internal Audit Office. We conducted limited-scope reviews of eight other internal audit units. We limited our review of these units to determining the scope of the internal audit work they performed and the degree to which the internal audit units were independent of the activities they audited.

We reviewed all federal grants over \$20 million for compliance with federal regulations except one, which was audited by other independent auditors. In all, we reviewed 34 of the 261 federal grants administered by the State for compliance features specified by the federal regulations governing the grants. These grants represent 95 percent of the federal funds received in fiscal year 1984-85. In addition, as part of our examination of the financial statements, we selected transactions related to other federal programs and reviewed these transactions for compliance with applicable federal regulations.

We also examined 17 agencies' transactions for compliance with state laws to identify problems that could materially affect the State's financial statements. These state laws provide state agencies with the requirements they must follow to ensure that the State maintains adequate control over budgeting, collecting, and disbursing state monies.

We present our report on the evaluation of the State's system of internal controls on page 45. In other sections of this report, we discuss the weaknesses in financial operations, weaknesses in

electronic data processing activities, and weaknesses in internal audit activities. We also discuss weaknesses in compliance with state regulations and weaknesses in compliance with federal regulations governing the administration of federal grants. We also present a detailed description of the weaknesses we found in each agency and provide our recommendations to correct those weaknesses.

Between July 1, 1984, and December 31, 1985, the Auditor General issued 71 audit reports. Many of these reports discussed improvements needed in internal controls. These reports are available to the public upon request. (Their titles are listed in Appendix A.)

AUDIT RESULTS

I

WEAKNESSES IN FINANCIAL OPERATIONS

The State's ability to produce financial statements on time continues to be a problem. Of the 294 agencies that are required to submit year-end financial reports to the State Controller, 176 agencies submitted their final reports late, delaying the completion of the State's audited financial statements.

We noted weaknesses in 16 of the state agencies whose financial operations we reviewed in detail. These 16 agencies account for approximately 75 percent of the State's spending. Financial operations include all reporting, revenue, and expenditure activities. Due to deficient reporting practices in 14 agencies, the same accounting transactions were not recorded consistently, and financial information was often incorrect.

Nine agencies did not adequately control revenue activities. As a result, the State not only lost the use of its money, it also lost potential interest revenue of at least \$1.5 million. Finally, 15 agencies did not adequately control expenditure activities. Because of this lack of control, 2 agencies disbursed more funds than they were authorized to spend and 4 agencies inappropriately paid employees. (Tables showing the distribution of weaknesses in financial operations by state agency appear on pages 53 through 55.)

Late Financial Reports

As part of our examination, we reviewed the promptness with which the agencies are submitting their year-end financial reports to the State Controller. Of the 294 agencies submitting year-end reports, 176 state agencies did not submit their reports to the State Controller by the required due dates or submitted revised reports after the due dates. Agencies that were late with their reports totaled 161. In addition, 24 agencies submitted revised financial reports to the State Controller after the required due dates, including 15 agencies whose original reports had been on time.

A State Controller's memorandum dated May 24, 1985, requires agencies having only General Fund appropriations to submit reports by July 22; the memorandum requires multi-funded agencies to submit General Fund reports by July 31 and reports for all other funds by August 20. Of the 294 agencies submitting year-end reports, 161 agencies (55 percent) submitted late reports, as shown in Table 1.

TABLE 1
AGENCIES SUBMITTING LATE REPORTS
TO THE STATE CONTROLLER
(AS OF JANUARY 7, 1986)

<u>Number of Days Late</u>	<u>Number of Agencies</u>	<u>Percent</u>
1-5	33	20
6-15	65	40
16-30	30	19
31-45	6	4
46-60	6	4
61-75	7	4
76-90	3	2
Over 90	9	6
Not In	<u>2</u>	<u>1</u>
	<u>161</u>	<u>100</u>

In addition, of the 294 agencies submitting year-end financial reports, there are 42 agencies that maintain their accounting records using the complex computerized California State Accounting and Reporting System (CALSTARS). Of the 42 agencies on the CALSTARS, 35 (83 percent) were submitted late, as shown in Table 2.

TABLE 2

**AGENCIES ON THE CALSTARS
SUBMITTING LATE REPORTS
TO THE STATE CONTROLLER
(AS OF JANUARY 7, 1986)**

<u>Number of Days Late</u>	<u>Number of Agencies</u>	<u>Percent</u>
1-5	8	23
6-15	9	25
16-30	7	20
31-45	2	6
46-60	1	3
61-75	5	14
76-90	1	3
Over 90	<u>2</u>	<u>6</u>
	<u>35</u>	<u>100</u>

The installation of the CALSTARS contributes to the continued lateness of financial reports. For example, the Department of Social Services submitted its 1983-84 financial reports for the General Fund 45 days after the due date prescribed by Department of Finance Management Memo 84-14. In fiscal year 1984-85, after converting from a manual accounting and reporting system to the CALSTARS, the department submitted its General Fund financial reports 98 days late, 43 days later than it did when it reported its financial operations manually.

While some of the delay may be caused by the conversion process, delays in reporting by agencies that have been on the CALSTARS for some time have not significantly improved. For example, the State Department of Education, which converted to CALSTARS in 1981, is still unable to submit its financial reports on time. For fiscal year

1984-85, the department submitted its General Fund reports 54 days late and its other funds' reports 34 days late.

The Standard and Poors Corporation, an organization that rates California's bonds, states that an annual examination of the General Purpose Financial Statements, prepared in accordance with generally accepted accounting principles, should be performed within six months of the end of the fiscal year. The state agencies' failure to submit final financial reports by the due dates delays the completion of the State's audited financial statements and may cause the Standard and Poors Corporation to lower the State's bond rating. Because bond interest rates generally increase as ratings decrease, noncompliance with the Standard and Poors Corporation's request may result in additional interest costs to the State.

Weaknesses in Reporting Activities

Fourteen state agencies did not adequately control reporting activities. Reporting activities include recording transactions in the accounting records and preparing various reconciliation and year-end financial reports. The following paragraphs detail the specific reporting activities in which we noted deficiencies and provide examples of the types of weaknesses that we found.

Preparation of Financial Reports

We reviewed the mathematical accuracy and completeness of the financial reports at 17 agencies. Two of these agencies inadequately prepared or failed to prepare all required financial reports. The Department of Motor Vehicles, for example, did not prepare its year-end financial reports in accordance with the State Administrative Manual. The department did not correctly prepare the Accrual Worksheet, the Final Budget Report, the Final Reconciliation of Controller's Accounts With Final Budget Report, and the Pre-closing Trial Balance. In another instance, the Board of Governors of the California Community Colleges did not include approximately \$9 million of amounts due to local governments on its Report of Accruals to the State Controller's Accounts for one of its funds. The board also inadequately prepared the Adjustments to Controller's Accounts and the Final Reconciliation of Controller's Accounts With Final Budget Report for two of its funds. Because of this type of deficiency, agencies' financial reports are neither complete nor accurate.

Accounting Practices

Eight agencies did not follow accounting practices prescribed by the Department of Finance, as stipulated in the State Administrative Manual, or as prescribed by other state regulations. As a result of these deficiencies, account balances were misstated, and transactions were not recorded consistently from agency to agency.

For example, the Department of Social Services inadequately accounted for prepayments to other governments at June 30, 1985, in the Social Welfare Federal Fund. In addition, the department failed to properly report advances of approximately \$84.8 million that were outstanding at June 30, 1985, and a loan from the General Fund that was made on June 28, 1985, to cover this advance. As a result, the Due to Other Funds account in the Social Welfare Fund was understated by approximately \$84.8 million.

Additionally, the Employment Development Department inaccurately reported the year-end accruals for the Consolidated Work Program Fund. Rather than accruing individual Job Training Partnership Act subgrant agreements, the department netted the total reported expenditures for the program against the total advances for the program. As a result, four accounts in the Consolidated Work Program fund were understated at June 30, 1985, by \$2 million each.

Reconciliations

Nine agencies did not adequately reconcile their accounts. Reconciliations are an important element of internal control because they provide a high level of confidence that transactions have been processed properly and that the financial records are complete. Failure to reconcile accounts may prevent the prompt detection of unauthorized transactions or errors and can result in the misstatement of account balances. For example, the schools unit of the State

Controller's office did not reconcile amounts it recorded as bond interest and redemption paid by the General Fund for the State School Building Aid Fund to the Monthly Statement of Bond Interest and Redemption received from the State Treasurer's office. As a result, the unit did not detect an error in its recording of a \$2.4 million General Fund interest payment for the State School Building Aid Fund that was charged to the School Lease-Purchase Fund. In addition, the State Department of Education did not reconcile State School Fund expenditures of \$8 billion to General Fund appropriations. As a result, the department inappropriately accrued a \$9.5 million liability.

Accountability for Fixed Assets

State agencies do not maintain sufficient records either to determine or to estimate the original cost of acquiring general fixed assets. Furthermore, state agencies do not take inventory of fixed assets promptly. For example, the State Department of Education, which has accountability for approximately \$4 million in state property, took approximately five years to complete the last physical inventory cycle instead of three years, as required by State Administrative Manual Section 8659. The lack of adequate controls over property could result in a loss of assets to the State.

Because state agencies have not maintained appropriate property records, the State is exposed to an increased risk of loss of assets,

and the State Controller was unable to present the General Fixed Assets Account Group in the State's General Purpose Financial Statements. As a result, for the past four years, the Auditor General has had to qualify his opinion on the fairness of the presentation of the General Purpose Financial Statements.

Weaknesses in Revenue Activities

Nine state agencies did not adequately control revenue activities. Revenue activities include the receipt of tax collections and federal grants, billings for delinquent taxes and for goods and services rendered, and subsequent follow-up and collection of those billings. The following paragraphs detail the specific revenue activities in which we noted deficiencies and provide examples of the types of weaknesses that we found.

Billing for and Collecting Receivables

Six agencies had inadequate procedures for billing for services rendered or for collecting money owed to the State. State Administrative Manual Sections 8776.3 and 8710.1 require agencies to bill as soon as possible after recognizing a claim due the State and to develop procedures for collecting accounts receivable.

The State lost at least \$1 million in potential interest income because the Department of Social Services did not promptly

obtain federal reimbursement for funds expended from the State Expenditure Revolving Fund and for costs of services provided by other agencies. In addition, the State Department of Education's accounts receivable collection procedures do not ensure that Child Development Program receivables are collected promptly. We observed the same weakness in fiscal year 1983-84; however, the State Department of Education has not performed any significant collection activities for receivables totaling approximately \$1.3 million. Because of the department's inadequate collection procedures, we believe that the department will not be able to collect this amount at all.

Depositing Collections

During our review of revenue activities, we found that two agencies did not promptly deposit collections. State Administrative Manual Section 8030.1(3) requires bank deposits to be made on the day of receipt if possible and no later than the next working day. However, at least 63 percent of all of the Department of Motor Vehicles' deposits from the department's unit for mail-in registration and driver's license renewal and at least 24 percent of deposits from all other units within the department are made later than the working day following receipt. As a result of the department's late deposits, we estimate that the State lost approximately \$500,000 in interest income during fiscal year 1984-85.

Recognizing Revenues

One agency did not accurately report to the State Controller revenue that had been earned as of June 30, 1985. State Administrative Manual Section 8290 requires that amounts that are earned but not received by the end of the fiscal year be accrued as revenue of the current year if they are estimated to be collectible within one year. The State Controller uses information reported by agencies to prepare the State's annual financial statements. If the agencies submit erroneous or incomplete information and the errors are not detected, the State's annual reports will be incorrect.

The California Student Aid Commission exhibited this weakness. The commission did not recognize all revenue from insurance premiums related to the 1984-85 fiscal year because the commission does not require the E.D.S. Corporation, its processor of student loans, to follow proper accrual procedures for financial reporting purposes. As a result, the E.D.S. Corporation did not include in its June report premium deposits of \$297,000 that it received between June 19 and June 30, 1985.

Separation of Duties Involving Revenues

Two agencies did not adequately separate incompatible duties involving revenues. State Administrative Manual Section 8080 lists the duties that should be segregated. For example, employees who initiate

or prepare invoices in conjunction with reconciling bank accounts and posting to the general ledger or any subsidiary ledger affected by cash transactions should not keep more than one book of original entry. However, at the Board of Governors of the California Community Colleges, one employee prepares and reviews invoices, maintains the invoice and disbursements registers (books of original entry), maintains the general ledger and receivables ledgers, and reconciles the bank statement. Unless incompatible duties are adequately separated, employees can effectively conceal irregularities.

Weaknesses in Expenditure Activities

Fifteen state agencies maintained inadequate control over expenditure activities. Expenditure activities include payroll, purchase of and payment for goods and contracted services, and payment of benefits or grants to individuals or other governmental entities. While agencies generally initiate and authorize requests for payment, the State Controller prepares and issues the warrants for payment. However, under certain circumstances as specified in the State Administrative Manual, agencies are authorized to prepare and issue payments from their own revolving funds. The following paragraphs detail the specific expenditure activities in which we noted deficiencies and provide examples of the types of weaknesses we found.

Control Over Payroll Expenditures

Four agencies did not adequately control payroll expenditures. As a result, some employees were not paid appropriately, and other employees were allowed to terminate employment before returning state property and repaying outstanding advances. For example, at June 30, 1985, separated employees owed the State \$3,149 in salary and travel advances because the Board of Equalization did not receive the separating employees' clearance forms before it issued the final pay warrants.

In addition, eight agencies did not ensure that lump sum leave payments made to separating employees had been computed correctly. As a result, these agencies made errors in the final payments to eight employees.

Control Over Disbursements

Nine agencies did not maintain proper control over disbursements. Failure to control disbursements can result in erroneous, unauthorized, or duplicate payments. For example, the Department of General Services did not adequately control disbursements made through the Architecture Revolving Fund. As a result, the Office of the State Architect spent \$278,000 more for six projects than the Department of Finance authorized. In another instance, the State lost approximately \$10,000 because the Department of Social Services failed to take advantage of vendor discounts during fiscal year 1984-85.

Control Over Revolving Fund

Five agencies did not adequately control the use of their revolving funds. We found weaknesses in preparing, recording, and reconciling revolving fund transactions. For example, the Department of Transportation exceeded the limit authorized for its office revolving fund 10 out of 12 months during fiscal year 1984-85. During the last 10 months of fiscal year 1984-85, the department overdrew its revolving fund checking account in the Centralized State Treasury System by an average of \$10.8 million per month. We observed the same condition during our financial audit for fiscal year 1983-84. When an agency overdraws its revolving fund, the agency is financing its operations with monies from other funds.

Recognizing Expenditures

Ten agencies did not accurately report their expenditures as of June 30, 1985. Because the State Controller uses the information that agencies submit to prepare the State's annual financial statements, agencies' failure to submit complete and accurate information could lead to errors in the State's financial statements.

For example, the Department of Water Resources must prepare financial statements on December 31 and on June 30 of every year for the benefit of bondholders and state government, respectively. The preparation of the financial statements requires full accrual

adjustments every six months. The department's accountant erroneously made the accrual adjustment at June 30, 1985, for a 12-month period rather than a 6-month period, thus overstating expenses in the California Resources Development Bond Fund by more than \$32.7 million. As a result, the department submitted incorrect financial reports to the State Controller.

The Department of Social Services also used improper accrual procedures. In most instances, the department's accounting personnel inappropriately accrued all of the remaining appropriation balance in the General Fund and the Federal Trust Fund without determining whether there was supporting documentation to substantiate these year-end accruals. Consequently, the expenditures of the Federal Trust Fund and the General Fund were overstated by \$288 million and \$36 million, respectively.

Separation of Duties Involving Disbursements

Two state agencies did not properly separate duties involving processing and distributing payroll warrants and revolving fund checks. One of these agencies did not adequately separate duties pertaining to payroll and personnel functions. At the Department of Transportation, employees who process attendance and other payroll documents at seven maintenance stations in the San Francisco district receive and distribute salary warrants. State Administrative Manual Section 8580.1 specifies that persons who receive salary warrants, distribute salary

warrants to employees, or handle warrants for any other purpose should not be authorized to process or sign personnel documents. Unless these duties are separated, an employee could authorize a fictitious payment for personal use.

GAAP Conversion

The State Controller prepares the Annual Report of the State of California in conformity with the State's legal basis of accounting and prepares the General Purpose Financial Statements in conformity with generally accepted accounting principles (GAAP) for governmental agencies. However, the Department of Finance has not provided sufficient instructions in the State Administrative Manual to make the conversion from the legal basis to the GAAP basis efficient and reliable. As a result, the financial information that agencies provide to the State Controller is frequently inadequate.

In addition, the financial information required under the GAAP basis of accounting is more extensive than the information provided by the legal basis of accounting. As a result, the State must develop additional information for proprietary funds and nonexpendable trust funds, lease commitments, the market value of the State's investments in securities, and university auxiliary organizations.

Although the State is in the process of converting from its legal basis to a GAAP basis in certain areas, until the State

incorporates all of the necessary generally accepted accounting principles into state law, the State must continue to spend time and money to convert its financial records so that they are comparable to those of other governmental entities and, therefore, acceptable to the investment community.

II

WEAKNESSES IN ELECTRONIC DATA PROCESSING ACTIVITIES

Of the 13 state agencies whose electronic data processing (EDP) activities we reviewed, 8 did not have adequate internal controls over their EDP activities. EDP activities include recording and processing daily business transactions as well as designing and maintaining the EDP system. We found weaknesses in separation of duties, systems documentation, access control, provision for backup, and input control. (A table showing the weaknesses in electronic data processing activities by state agency appears on page 57 of this report.)

Separation of Duties

Two state agencies did not separate incompatible duties. For example, at the Department of Water Resources, some computer operator duties are assigned to individuals who also have responsibility for monitoring computer operations. For instance, the monitoring of the computer mainframe is assigned to data control technicians, and the individual who has the responsibility for monitoring the use of the data library also assigns access passwords. These control weaknesses could result in unauthorized changes to data files.

System Documentation

Two state agencies have not properly documented their EDP systems. For example, the Board of Governors of the California Community Colleges, which apportions approximately \$1.1 billion annually to community colleges, does not have adequate documentation of the planning and testing of its EDP system and programs, its programming changes resulting from statutory requirements, and its creation and maintenance of the system and programs. Effective internal control over EDP activities requires evidence of controls over system design, development, testing, and changes of the EDP system and programs.

Access Controls

Two state agencies had inadequate controls over access to documentation, files, programs, and hardware. For example, the Department of Motor Vehicles has not adequately restricted access to its EDP system. The system does not lock the user out after a given number of unsuccessful attempts to gain access from an on-line terminal. Additionally, the department's system does not record all unsuccessful attempts to gain access with an unauthorized password. Failure to limit access to an EDP system increases the potential for unauthorized modifications to files as well as misuse of the computer hardware.

The Department of Water Resources also has not adequately restricted access to its EDP system. System software programmers have unrestricted and unsupervised access to the computer room. Moreover, the department maintains system, program, and data files in the library and on the floor of the computer room without restricting access to the files. This lack of adequate restriction could result in unauthorized manipulation of accounting, program, and system information.

Backup Provisions

We also noted that the Department of Water Resources and the Department of Motor Vehicles do not have adequate EDP backup procedures. For example, the Department of Water Resources does not store all critical EDP history files at an off-site location to ensure safekeeping in the event of an accident or natural disaster at the EDP facility. In the event of an accident or natural disaster, the department would have difficulty recreating billing information and financial statements.

Similarly, the Department of Motor Vehicles does not have provisions for off-site backup hardware for its EDP systems in the event of a major disaster. The department has advised us that, at this time, there are no facilities in California that have adequate hardware that is compatible with the department's hardware and is also capable of processing the department's volume of work. Consequently, a major

shutdown of the department's EDP system could result in the loss of revenues to the State and local governments and the loss of information data bases used by law enforcement agencies.

Input Controls

Four state agencies have inadequate input controls. For example, the State Department of Education's accounting personnel do not always request or justify the use of fund control overrides. We observed a similar weakness in this department in fiscal years 1982-83 and 1983-84. When the proper authorization and justification process is not used, the department minimizes the effectiveness of the fund control edits.

Finally, the Department of Social Services did not promptly review its EDP system's error report during fiscal year 1984-85. Effective internal control over EDP activities requires agencies to review and control all errors detected by the EDP system and to ensure that transactions are corrected and reentered into the system. We noted that in some cases the department did not resolve errors detected by its EDP system for over three months; as a result, reports were misstated.

III

VARIANCES FROM INTERNAL AUDIT STANDARDS

Six of the 13 internal audit units we reviewed did not completely adhere to the "Standards for the Professional Practice of Internal Auditing" (professional standards) of the Institute of Internal Auditors, Inc. California Government Code Section 1236 requires that state agencies' internal audit units comply with these professional standards, which embody the goals of internal auditing that pertain to independence, professional proficiency, scope of work to be performed, conduct in the performance of audit work, and management of internal auditing units.

Internal audit units are a basic component of internal control. These units review and evaluate an agency's internal controls and appraise the efficiency of the agency's operations. They provide management with recommendations to remedy internal control weaknesses, thus increasing the overall efficiency of agencies' operations. In addition, under certain conditions internal audit units may assist external auditors in performing audit work, thus reducing the State's costs for audits.

Unless the internal audit units comply with professional standards, management lacks assurance that the work of the internal auditors can be relied upon. In addition, external auditors may be

precluded from using the work of internal auditors when the internal auditors do not comply with professional standards. (A table showing variances from internal auditing standards by state agency appears on page 59 of this report.)

Independence Standard

Four internal audit units were not organizationally independent of all the activities they audited. For example, the internal auditor of the Department of Alcohol and Drug Programs reports to the Chief of the Financial Planning and Audit Section. The chief has authority over the activities that the internal auditor reviews, such as accounting, financial planning, and contracting. Thus, the internal auditor reviews activities and functions managed by his supervisors. Lack of organizational independence can limit an auditor's objectivity.

The professional standards require that the internal auditor be responsible to an individual in the department with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of reports, and appropriate action on audit recommendations.

Performance of Work Standard

Three of the 13 agencies we reviewed did not comply with the professional standards related to the performance of audit work. For example, the workpapers of the State Department of Education's Internal Management Audits section did not provide enough information to support audit findings and recommendations. The professional standards require that information be sufficient, competent, relevant, and useful for providing a sound basis for audit findings and recommendations. The auditors did not adequately document their sources of information, their audit methodologies, their analyses, and their conclusions. These types of deficiencies make it difficult to review workpapers and to determine whether there is sufficient evidence to support audit results.

Management of the Internal Auditing Department Standard

The internal auditing department of one agency we reviewed, the Department of Water Resources' Internal Audit Office, has no formal audit charter outlining the purpose, authority, and responsibility of the office as required by the standards related to management of the internal auditing department. Proper management of an internal auditing department ensures that the audit work fulfills management's objectives and that the internal auditing department efficiently and effectively employs its resources.

IV

WEAKNESSES IN COMPLIANCE
WITH STATE REGULATIONS

The State Constitution and certain state statutes establish the requirements that state agencies must follow to ensure that the State maintains adequate control over budgeting, collecting, and disbursing state monies. We tested 17 state agencies' compliance with state requirements to identify weaknesses that could materially affect the State's financial statements. Our objective was to determine whether the State could be assured of the following controls:

- The budget is controlled according to the directions of the Legislature;
- Agency financial records agree with those of the State Controller;
- Records of funds held by the State Treasurer agree with the records of the State Controller;
- Securities purchased and held by the State are limited to those authorized by Government Code Section 16430.
- Bank deposits are protected by collateral held by the State Treasurer as required by Government Code Section 16500;

- Procurements of materials, supplies, equipment, and services are made in accordance with the Public Contract Code;
- Investment income of the Pooled Money Investment Account is properly allocated to state funds and to local agencies investing through the Local Agency Investment Fund;
- School apportionments are made in accordance with various Education Code sections;
- Sales tax collections are distributed to local governments in accordance with laws and contracts with local governments;
- Proceeds of state gasoline taxes are used in accordance with Article XIX of the State constitution;
- Funds for local health programs are allocated to local governments in accordance with various Welfare and Institutions Code sections;
- Motor vehicle license fees and trailer coach fees are apportioned to cities and counties in accordance with Section 11005 of the Revenue and Taxation Code; and
- Audits of local service providers and educational agencies are performed or monitored in accordance with Welfare and

Institutions Code Section 11462 and Education Code Section 41020, respectively.

Our examination did reveal three areas in which the State did not comply with state requirements. These areas are discussed in the following paragraphs.

Procurements

Not all state agencies are evaluating contracts within the time specified by the Public Contract Code. We tested 57 contracts in 11 state agencies. The contract term for 45 of these contracts had ended at least 30 days before our test; however, we found that the state departments had not evaluated 25 of the 45 completed contracts. These 25 contracts totaled \$928,000. Public Contract Code Section 10347 requires each state agency to prepare and submit, within 30 days of the completion date of the contract, an evaluation of each contract awarded. The Department of General Services reviews these evaluations before entering into a new contract with the vendor. If state agencies do not promptly prepare and submit the contract evaluations to the Department of General Services, the department might inadvertently contract with a vendor who is unreliable.

School Apportionments

The Local Assistance Bureau of the State Department of Education did not calculate the School Improvement Program entitlements for fiscal year 1984-85 in accordance with provisions of the Education Code. The Local Assistance Bureau gave those school districts that were disallowed a cost of living adjustment as determined by Education Code Section 52048 the same amount of funding that the school districts received in fiscal year 1983-84. However, based on an interpretation of the Education Code made by the Auditor General's legal counsel, the Local Assistance Bureau should have based its calculations of the School Improvement Program funding for fiscal year 1984-85 on Education Code Sections 52046(b)(1) and 52046(b)(2) rather than Section 52048. Sections 52046(b)(1) and 52046(b)(2) require an adjustment of the previous year's funding by the student attendance figures. If the bureau does not apply Sections 52046(b)(1) and 52046(b)(2) to apportionments, school districts whose student attendance figures increase or decrease from year to year will not be granted a corresponding increase or decrease in the entitlement.

Audits

The Department of Social Services did not perform audits required by Welfare and Institutions Code Section 11462 on some of the group homes that accept children whose placement is funded under the Aid to Families with Dependent Children - Foster Care (AFDC-FC)

program. Therefore, the department lacks assurance that the group homes are using state and federal funds for authorized purposes, and it may be jeopardizing the continuation of federal grant funds.

We also noted that the Department of Finance failed to arrange for audits of local educational agencies that had not submitted the required audit reports to the State Department of Education in accordance with Education Code Section 41020. For example, our review of the State Department of Education's National School Lunch and School Breakfast programs revealed that two school districts have not submitted audit reports for the year ended June 30, 1984. One of these districts also failed to submit audit reports for the fiscal years ended June 30, 1982 and 1983, even though that district received more than \$900,000 in federal funds from the National School Lunch and School Breakfast programs between July 1, 1981, and June 30, 1984. Without an audit report, the State Department of Education is unable to verify that those funds were properly spent.

WEAKNESSES IN COMPLIANCE
WITH FEDERAL REGULATIONS

The federal government requires the State to comply with specific criteria on each of the grant programs (programs) that the federal government gives to the State. Typically, federal requirements address recipient eligibility, reimbursable costs, program monitoring, and reporting. State agencies failed to comply with at least one federal regulation in 31 of the more than 34 programs we reviewed. The federal government could require the State to return all funds that the State spent while not in compliance with federal grant requirements.

Our report on compliance with federal grant requirements begins on page 209 of this report. In addition, a table showing the distribution of weaknesses in compliance with federal regulations by program appears on page 61 and 62 of this report. The following paragraphs detail the specific areas in which we noted that state agencies did not comply with federal regulations and provide some examples of the instances of noncompliance we found.

Federal Financial Reports

Most federal programs require the State to submit financial reports periodically. We reviewed federal financial reports for mathematical accuracy, reconciliation to the accounting records, and

promptness of submission. We found that the State had incorrectly prepared, failed to prepare, or did not submit on time required federal reports for 15 programs we reviewed. In one case, we estimate that the State lost over \$300,000 in potential interest earnings because of errors in federal reports.

Failure to reconcile federal financial reports to the accounting records can result in the misstatement of claims for cash advances and reimbursements from the federal government and may also prevent the early detection of irregularities such as erroneous adjustments and failure to receive federal funds.

The Student Aid Commission had an outside contractor accumulate information that the commission includes in its quarterly federal reports. Because the commission does not check the accuracy of accumulated information, it was unaware that its federal reports contained errors. As a result of the errors, the federal government did not reimburse the commission for administrative costs until the commission submitted accurate reports. We estimate that the State lost approximately \$350,000 in potential interest earnings because of the commission's delay in submitting accurate reports.

Moreover, five state agencies did not submit required federal reports on time. For example, the Office of Economic Opportunity was late in submitting its required 1984-85 annual report on the number and income level of households served under the Low-Income Home Energy

Assistance program. Additionally, the information contained in the report was not accurate.

Support for Expenditures

To claim federal reimbursement for program costs, the State must have documentation that costs were incurred and appropriately charged to the federal program. However, the State did not maintain adequate support for program costs in 12 of the programs that we reviewed.

For example, the State Department of Education corrected reimbursement claims for the National School Lunch, School Breakfast, and Child Care Food programs without obtaining proper documentation from the sponsors. The department corrected inaccurate reimbursement claims through telephone conversations with the sponsors but did not request that the sponsors submit amended claims. Without adequate documentation, the department is in an indefensible position when a discrepancy occurs between its records and a sponsor's records.

In addition, the Department of Health Services' Toxic Substances Control Division paid invoices submitted by one of the contractors despite the lack of supporting documentation such as travel itineraries, airline tickets, car rental receipts, automobile mileage, and other miscellaneous receipts. Of the audited total of \$22,980 paid to the contractor for travel and miscellaneous costs for fiscal year 1984-85, there was support for only \$9,484 of paid invoices.

Program Monitoring and Auditing

For many of the programs we reviewed, federal regulations required the State to monitor program activities, to audit programs, or to enforce audit requirements. However, the State did not adequately perform its monitoring and auditing responsibilities in 22 of the programs we reviewed.

For example, the State Department of Education did not adequately monitor Migrant Education Program activities. Federal regulations for that program state that only properly identified migratory children are eligible to participate in the program. However, the Department's Child Development Division staff do not interview any of the parents of migratory children to ensure that recruiters from local agencies are correctly assessing eligibility.

Additionally, federal regulations require that audits of the National School Lunch, School Breakfast, and Child Care Food programs be conducted not less frequently than once every two years. However, we found that 14 of the 70 Child Care Food Program sponsors we tested either did not submit an audit report to the State Department of Education or submitted a report that did not meet the biennial audit requirement. In addition, 59 sponsors participating in the National School Lunch and School Breakfast programs have not submitted acceptable audit reports within the guidelines required by federal regulations. Each of these sponsors received more than \$25,000 during

fiscal year 1983-84, and the sponsors received over \$5,000,000 in total during that period. One particular school district received over \$900,000 in federal funds under the National School Lunch and School Breakfast programs and has failed to submit audit reports for fiscal years 1981-82, 1982-83, and 1983-84.

Federal regulations require the departments to develop procedures to provide proper control over cash advances to counties. We found that the Department of Mental Health does not provide adequate control over cash advanced to counties for Alcohol, Drug and Mental Health Services block grants. The department does not review the counties' requests for cash advances to determine if the counties meet all federal and state requirements. For instance, as of October 31, 1985, Los Angeles County and Sacramento County had not submitted either their final cost reports for fiscal year 1983-84 or their quarterly Grant Financial Status Reports for the quarter ending June 30, 1985. However, these counties received cash advances of \$5,347,000 and \$25,725, respectively, from December 1, 1984, through June 30, 1985, even though the department's policy requires that cash advances to counties be suspended if they fail to submit final cost reports by the due date.

Drawdown and Disbursement of Federal Funds

Federal regulations require the State to minimize the time between the transfer of funds from the U.S. Treasury and the

disbursement of those funds by the State. Similar federal requirements apply to advances of federal funds from the State to grant recipients.

Three state agencies did not draw or disburse federal funds in accordance with federal regulations. One agency requested federal funds before they were needed, and other agencies did not request federal funds as soon as they were entitled to them. Delay in requesting federal funds results in a loss of interest revenue for the State, while early drawdowns of federal funds allows the State to earn interest on monies that could be available to the federal government.

For example, of the \$606 million of federal funds that we reviewed at the State Department of Education, approximately \$130 million was drawn and held for periods of 11 to 34 days before the State disbursed the money. Federal guidelines require that the timing and amount of cash advances of federal funds be as close as is administratively feasible to the State's actual disbursement.

On the other hand, the Department of Rehabilitation, during the first nine months of fiscal year 1984-85, requested federal monies after claims were paid by the State Controller. We estimate that, as a result, the State lost approximately \$300,000 in potential interest earnings.

CONCLUSION AND RECOMMENDATIONS

During our review of 32 state agencies, we noted widespread weaknesses in the internal controls designed to protect the State's assets. These weaknesses occurred primarily because state agencies did not follow the procedures prescribed in the State Administrative Manual. As a result, the State lost at least \$2 million in foregone interest and lost discounts.

Of particular concern is the agencies' late submission of year-end financial reports. Late submission of the agencies' financial reports delays the completion of the State's audited financial statements. Because of the delay in receiving the State's audited financial statements, the Standard and Poors Corporation, an organization that rates bonds, may lower California's bond rating. This action may result in additional interest costs to the State, since bond interest rates generally increase as ratings decrease.

Recommendations

The State of California must place greater emphasis on and allocate a larger portion of available resources toward improving its accounting, auditing, financial, and administrative control systems. These systems are the key to ensuring that all state funds have proper

accounting, that budgets are not exceeded, that cash and other assets are protected from loss or theft, and that accurate financial information is available to the Governor and the Legislature while they are making financial decisions.

The Department of Finance should monitor state agencies to ensure that agencies submit their year-end financial reports to the State Controller by the due dates required by State Administrative Manual Section 7990 and revised annually by the State Controller's memorandum. The Department of Finance should also monitor the state agencies to ensure that agencies correct the other weaknesses we identified.

The management letters describing the weaknesses we found in each state agency and our recommendations to correct those weaknesses are presented on pages 63 through 207.

**REPORT ON THE STUDY AND EVALUATION
OF INTERNAL CONTROL**



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State of California

We have examined the General Purpose Financial Statements of the State of California as of and for the year ended June 30, 1985, and have issued our report dated December 20, 1985. We did not examine the financial statements of the Pension Trust Funds, which reflect total assets constituting 67 percent of the Fiduciary Funds. We also did not examine the financial statements of certain Enterprise Funds, which reflect total assets and revenues constituting 60 percent and 68 percent, respectively, of the Enterprise Funds. In addition, we did not examine the University of California Funds.

As part of our examination, we studied the State's system of internal controls, including applicable internal controls used in administering federal financial assistance programs, to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and by the standards for financial and compliance audits of the Comptroller General of the United States contained in the U.S. General Accounting Office Standards for Audit of Governmental Organizations, Programs, Activities, and Functions; and the provisions of the Office of Management and Budget (OMB) Circular A-128, Audits of State and Local Governments. For this report, we classified the system of internal controls of the State of California into three areas: financial operations, electronic data processing activities, and internal audit activities.

We did not study the system of internal controls for the Pension Trust Funds, certain Enterprise Funds, and the University of California Funds because these funds were examined by other auditors.

The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for (1) expressing an opinion on the State's General Purpose Financial Statements, and (2) determining compliance with federal grant requirements, laws, and regulations. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal controls taken as a whole or on any of the categories of controls identified above.

The Department of Finance and the management of the agencies of the State of California are responsible for establishing and maintaining a system of internal accounting controls. In fulfilling this responsibility, they are required to make estimates and judgments to assess the expected benefits and related costs of control procedures.

The objectives of a system of internal controls, including internal control systems used in administering federal financial assistance programs, are to provide management with reasonable assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with the authorization and policy of the Department of Finance and other agencies, that transactions are recorded properly, and that management is managing federal assistance programs in compliance with applicable laws and regulations. Proper recording of transactions permits the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal controls, errors or irregularities may nevertheless occur and not be detected. Also, projecting any evaluation of the system to future periods is subject to the risk that the degree of compliance with the procedures may deteriorate or that procedures may become inadequate because of changes in conditions.

Our study and evaluation, made for the limited purposes described in the fourth paragraph, would not necessarily disclose all material weaknesses in the State's system of internal controls. Accordingly, we do not express an opinion on the system of internal accounting controls of the State of California taken as a whole or on any of the categories of controls identified in the second paragraph. However, our evaluation disclosed a weakness in accounting for general fixed assets that could result in errors or irregularities that may not be promptly detected and that involves amounts that could have a material effect on the General Purpose Financial Statements of the State of California.

Weakness in Accounting for General Fixed Assets

The State does not maintain sufficient records to support the cost of general fixed assets. Furthermore, the State does not consistently inventory fixed assets and does not record all fixed assets in the property records. This weakness in accountability results in an increased risk of loss of assets. Furthermore, it makes it impossible for the State Controller to present the General Fixed Assets Account Group in the General Purpose Financial Statements.

Recommendation

The Department of Finance should require all agencies to comply with property accounting procedures that would allow the State Controller to include the General Fixed Assets Account Group in the General Purpose Financial Statements. Complying with property accounting procedures would assist in safeguarding the assets of the State.

We considered this weakness in determining the nature, timing, and extent of audit tests to be applied in (1) our examination of the financial statements and (2) our examination and review of compliance with laws and regulations, noncompliance with which could have a material effect on the allowability of program expenditures for federal financial assistance programs. Our reporting of this weakness does not modify our December 20, 1985, report on the General Purpose Financial Statements. While our study did not disclose any other material weaknesses, it did disclose certain conditions requiring the attention of management. The remaining sections of this report will discuss these conditions.

This report is intended for the use of the State of California. This restriction is not intended to limit the distribution of this report which, upon acceptance by the Joint Legislative Audit Committee, is a matter of public record.

OFFICE OF THE AUDITOR GENERAL



CURT I. DAVIS, CPA
Deputy Auditor General

February 14, 1986

**WEAKNESS IN INTERNAL CONTROL
DISTRIBUTION BY STATE AGENCY**

WEAKNESSES IN REPORTING ACTIVITIES

<u>Agency</u>	<u>Reconciliations</u>	<u>Accounting Practices</u>	<u>Financial Statements</u>	<u>Accounting Over Property/Inventory</u>	<u>Other</u>
California Community Colleges, Board of Governors of the		X	X	X	
California State University, Sacramento		X			
California Student Aid Commission	X			X	X
Corrections, Department of	X		X		
Education, State Department of	X	X	X	X	X
Employment Development Department	X	X			
Equalization, Board of	X	X			
General Services, Department of	X	X	X	X	X
Motor Vehicles, Department of			X		
Social Services, Department of	X	X	X		
State Controller	X				
State Treasurer	X				
Transportation, Department of		X			
Water Resources, Department of			X		

WEAKNESSES IN REVENUE ACTIVITIES

<u>Agency</u>	<u>Separation of Duties</u>	<u>Billing and Collecting Receivables</u>	<u>Identifying and Depositing Collections</u>	<u>Recognizing Revenues</u>	<u>Other</u>
California Community Colleges, Board of Governors of the	X	X			
California Student Aid Commission	X			X	
Education, State Department of		X			
Equalization, Board of				X	X
General Services, Department of		X			
Motor Vehicles, Department of			X		X
Social Services, Department of		X			
State Treasurer		X			
Transportation, Department of		X	X		X

WEAKNESSES IN EXPENDITURE ACTIVITIES

<u>Agency</u>	<u>Separation of Duties</u>	<u>Control Over Payroll</u>	<u>Control Over Revolving Fund</u>	<u>Control Over Disbursements</u>	<u>Recognizing Expenditures</u>	<u>Other</u>
California Community Colleges, Board of Governors of the					X	
California State University, Sacramento		X	X		X	
California State University, San Jose				X	X	
California Student Aid Commission		X		X	X	
Corrections, Department of				X		
Education, State Department of	X		X	X	X	X
Employment Development Department					X	
Equalization, Board of		X				
General Services, Department of		X		X	X	X
Health Services, Department of				X	X	
Motor Vehicles, Department of			X			
Social Services, Department of				X	X	X
State Controller				X		
Transportation, Department of	X		X	X		
Water Resources, Department of			X		X	

WEAKNESSES IN ELECTRONIC DATA PROCESSING ACTIVITIES
DISTRIBUTION BY STATE AGENCY

<u>Agency</u>	<u>Separation of Duties</u>	<u>Access Controls</u>	<u>System Documentation</u>	<u>Backup Provisions</u>	<u>Input Controls</u>	<u>Other</u>
California Community Colleges, Board of Governors of the			X			
California Student Aid Commission						X
Education, State Department of	X				X	
Employment Development Department					X	X
Motor Vehicles, Department of		X		X		
Social Services, Department of			X		X	
State Controller					X	
Water Resources, Department of	X	X		X		

**VARIANCES FROM INTERNAL AUDIT STANDARDS
DISTRIBUTION BY STATE AGENCY**

<u>Agency</u>	<u>Independence Standard</u>	<u>Professional Proficiency Standard</u>	<u>Scope of Work Standard</u>	<u>Performance of Work Standard</u>	<u>Management of Internal Auditing Department Standard</u>
<u>Full Scope Reviews</u>					
State Controller				X	
Water Resources, Department of				X	X
<u>Limited Scope Reviews</u>					
Alcohol and Drug Programs, Department of	X				
Education, State Department of	X			X	
General Services, Department of	X				
Rehabilitation, Department of	X				

**WEAKNESSES IN COMPLIANCE WITH FEDERAL REGULATIONS
DISTRIBUTION BY PROGRAM**

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Inadequate/Late Reports	Inadequate Support for Expenditures	Inadequate Monitoring/Auditing	Late Draw/Disbursement of Federal Funds	Other
	<u>U.S. Department of Agriculture</u>						
10.550	Food Distribution	Department of Education				X	X
10.551	Food Stamps	Department of Social Services	X	X	X		
10.553	School Breakfast Program	Department of Education		X	X	X	X
10.555	National School Lunch Program	Department of Education		X	X	X	X
10.558	Child Care Food Program	Department of Education		X	X	X	X
	<u>U.S. Department of Health and Human Services</u>						
13.633	Special Programs for the Aging - Title III, Parts A and B - Grants for Supportive Services and Senior Centers	Department of Aging	X				
13.645	Child Welfare Services	Department of Social Services	X		X		
13.646	Work Incentive Program	Employment Development Department Department of Social Services	X	X	X	X	X
13.665	Community Services Block Grant	Office of Economic Opportunity			X		X
13.667	Social Services Block Grant	Department of Social Services		X	X	X	
13.679	Child Support Enforcement	Department of Social Services	X		X	X	
13.808	Assistance Payments - Maintenance Assistance	Department of Social Services	X	X	X	X	
13.814	Refugee Assistance - State Administered Programs	Department of Social Services	X	X	X	X	
13.818	Low-Income Home Energy Assistance	Office of Economic Opportunity	X		X		X
13.992	Alcohol and Drug Abuse and Mental Health Services Block Grant Programs	Department of Alcohol and Drug Department of Mental Health			X X		
	<u>U.S. Department of Housing and Urban Development</u>						
14.228	Community Development Block Grant - State Program	Department of Housing and Community Development			X		X

<u>Federal Catalog Number</u>	<u>Grantor Agency/Program Title</u>	<u>Administering State Agency</u>	<u>Inadequate/Late Reports</u>	<u>Inadequate Support for Expenditures</u>	<u>Inadequate Monitoring/Auditing</u>	<u>Late Draw/Disbursement of Federal Funds</u>	<u>Other</u>
	<u>U.S. Department of Labor</u>						
17.225	Unemployment Insurance	Employment Development Department	X				
17.246	Employment and Training Assistance - Dislocated Workers	Employment Development Department	X		X		X
17.250	Job Training Partnership Act	Employment Development Department	X		X		X
	<u>U.S. Department of Transportation</u>						
20.205	Highway Planning and Construction	Department of Transportation			X		X
	<u>U.S. Environmental Protection Agency</u>						
66.802	Hazardous Substance Response Trust Fund (Superfund)	Department of Health Services		X			X
	<u>U.S. Department of Education</u>						
84.010	Educationally Deprived Children - Local Educational Agencies	Department of Education		X	X	X	X
84.011	Migrant Education - Basic State Formula Grant Program	Department of Education			X	X	X
84.027	Handicapped Preschool and School Programs	Department of Education	X	X		X	X
84.032	Higher Education Act Insured Loans	Student Aid Commission	X				
84.048	Vocational Education - Basic Grants to States	Department of Education	X	X	X	X	X
84.126	Rehabilitation Services - Basic Support	Department of Rehabilitation	X			X	X
84.151	Improving School Programs - State Block Grants	Department of Education			X	X	X
	<u>Miscellaneous</u>						
98.003	Shared Revenue - Forest Resources	State Controller					X
98.004	Shared Revenue - Grazing Land	State Controller					X
98.005	Shared Revenue - Potash/Sodium Lease	State Controller					X

**DETAILED DESCRIPTION OF
WEAKNESSES BY STATE AGENCY**

INDEX OF STATE AGENCIES

<u>Agency</u>	<u>Page</u>
Department of Aging	67
Department of Alcohol and Drug Programs	68
Board of Governors of the California Community Colleges	70
California State University	76
California Student Aid Commission	79
Department of Corrections	86
Office of Economic Opportunity	89
Department of Education	94
Employment Development Department	123
Board of Equalization	132
Department of General Services	136
Department of Health Services	145
Department of Housing and Community Development	149
Department of Mental Health	150
Department of Motor Vehicles	154
Department of Rehabilitation	161
Department of Social Services	164
State Controller	182
State Treasurer	192
Department of Transportation	195
Department of Water Resources	204

DEPARTMENT OF AGING

The Department of Aging administers one of the 34 federal programs we reviewed. It is the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.633.

Item 1.

Accuracy of Federal Financial Reports

Finding:

The department did not perform important reconciliations that would provide reasonable assurance that the department's Federal Cash Transaction Report and the department's Federal Financial Status Report are accurate. The data in the federal cash journal, which are posted to the Federal Cash Transaction Report, were not reconciled to the department's general ledger accounts that are reconciled to the State's central accounts maintained by the State Controller. In addition, the department did not reconcile its Federal Financial Status Report of expenditures to the Area Agency on Aging financial status reports of expenditures. The Area Agency on Aging financial status reports of expenditures were compiled by the department to prepare its Federal Financial Status Report.

Criteria:

The Office of Management and Budget Circular A-102, Attachment G, requires that federal financial reports contain accurate and reliable financial data. State Administrative Manual Section 7900 discusses the importance of reconciliations. Reconciliations represent an important element of internal control because they provide a reasonable assurance that transactions have been adequately processed and that financial records are complete.

Recommendation:

The department should reconcile the data on the Federal Cash Transaction Report to the department's federal cash journal and to applicable department general ledger accounts that are reconciled to the State Controller central accounts. In addition, the department should reconcile the data on its Federal Financial Status Report to the data on the Area Agency on Aging financial status reports.

DEPARTMENT OF ALCOHOL AND DRUG PROGRAMS

The Department of Alcohol and Drug Programs administers one of the 34 federal programs we reviewed. It is the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.992.

Item 1. Inadequate Control Over Cash Advances to Counties

Finding: The department did not provide adequate control over cash advances to counties for Alcohol, Drug, and Mental Health Services Block Grant program. The department requires counties to submit their annual County Plan and Budget on or before October 1. In our test of 13 out of 58 counties, we found that the department's Program Review Section approved monthly cash advances to 11 counties for the month of November 1984, before the department received each county's annual County Plan and Budget. The department's policy requires suspension of cash advances to counties if they fail to submit their final County Plan and Budget on time. Failure to adequately control cash advances to counties may jeopardize the State's continued receipt of federal block grants.

Criteria: U.S. Office of Management and Budget Circular A-102, Attachment G, requires the department to develop and implement procedures that will provide proper control over cash advances to secondary recipients.

Recommendation: To ensure compliance with federal requirements, the Program Review Section should follow the department's policy to suspend cash advances to counties if they fail to submit the required reports on time.

Item 2. The Internal Auditor Is Not Sufficiently Independent

Finding: The department's internal auditor is not sufficiently independent of the units he audits. The internal auditor reports to the Chief of the Financial Planning and Audit Section, who reports to the Chief of the Division of Administration. The Chief of Financial Planning and Audit Section has authority over the activities that the internal auditor reviews, such as accounting, financial planning, and contracting. Furthermore, the Chief of the Division of Administration also has authority over functions the internal auditor reviews, such as computer services and management services. Thus,

the internal auditor reviews functions managed by his supervisors.

Criteria: California Government Code Section 1236 requires state agencies that conduct internal auditing activities to use the "Standards for the Professional Practice of Internal Auditing" of the Institute of Internal Auditors, Inc. The standards state that the internal auditor should be responsible to an individual in the department with sufficient authority to promote independence and to insure broad audit coverage, adequate consideration of reports, and appropriate action on audit recommendations.

Recommendation: The director of the department should require the internal auditor to report directly to the deputy director.

BOARD OF GOVERNORS OF THE CALIFORNIA COMMUNITY COLLEGES

Item 1. Late Financial Reports

Finding: Multi-funded agencies are required to submit financial reports for the General Fund by July 31; financial reports for all other funds must be submitted by August 20. However, the board did not submit its financial reports to the State Controller until October 6, 1985. In addition, the board submitted several revisions to its year-end financial reports on November 21, 1985. The board's fiscal officer attributes the board's inability to meet financial report deadlines primarily to understaffing in the Accounting and Budget Section throughout most of fiscal year 1984-85. Also, the board's fiscal officer noted that most of the accounting personnel were not adequately trained for using the California Statewide Accounting and Reporting System (CALSTARS). As a result of these factors, a backlog of accounting work existed at year-end. Failure to submit financial reports by the required deadlines delays the State Controller's compilation of financial statements for the State of California.

Criteria: State Controller's office memorandum, dated May 24, 1985, requires multi-funded agencies to submit their General Fund financial reports by July 31. Financial reports for funds other than the General Fund must be submitted by August 20.

Recommendation: The board should implement procedures to ensure that it submits its year-end financial reports by the required deadlines. Also, the board and the Department of Finance should adequately train the board's accounting personnel in using the CALSTARS.

Item 2. Inadequate Preparation of Financial Reports

Finding: The board did not submit complete and accurate year-end financial reports to the State Controller. We found that the board did not include an accrual on a year-end financial report, incorrectly reported adjustments to the State Controller, failed to prepare several required year-end financial reports, did not accurately classify expenditures and operating transfers on two required year-end financial reports, and did not adequately report an operating transfer in required year-end financial

reports. Because of these deficiencies, the board's financial reports are neither complete nor accurate.

We found the following specific deficiencies:

1. The board did not include an accrual of approximately \$9 million on the Report of Accruals to Controller's Accounts for the General Fund Due To Local Governments account balance.
2. The board incorrectly reported adjustments to two accounts included on the Adjustments to Controller's Accounts for the General Fund.
3. The board failed to prepare the General Fund Final Reconciliation of Controller's Accounts With Final Budget Report and the Final Budget Report for a local assistance appropriation that totaled approximately \$2.2 million.
4. The board did not accurately classify expenditures on the State School Fund Final Reconciliation of Controller's Accounts With Final Budget Report and operating transfers in on the State School Fund Final Budget Report.
5. The board did not report operating transfers of \$1 million from the General Fund to the Foster Children and Parent Training Fund in its General Fund year-end financial reports.

Criteria: Department of Finance Management Memo 85-11, dated July 2, 1985, reminded agency executives of their responsibility for preparing accurate year-end financial reports. State Administrative Manual Sections 7950 through 7979 describe how year-end financial reports should be prepared.

Recommendation: The board should maintain sufficiently detailed accounting records to accurately and completely prepare all required year-end financial reports.

Item 3. Improper Identification of Encumbrances

Finding: On its General Fund Report of Accruals, the board inappropriately reported approximately \$3.3 million of amounts due to other governments as encumbrances. The board did not analyze its Due To Other Governments account balance to determine whether goods were received or services were provided before or after June 30. If the board does not properly

identify encumbrances in its financial reports, the State Controller does not have sufficient information to prepare financial statements for the State of California in accordance with generally accepted accounting principles.

Criteria: State Controller's office memorandum, dated May 24, 1985, instructed agencies to report the amount of encumbrances applicable to their accruals in such a way that financial statements could be prepared in accordance with generally accepted accounting principles. Under generally accepted accounting principles, encumbrances are that portion of the accruals that represent goods received or services provided after June 30.

Recommendation: During year-end closing, the board should analyze its accruals to determine whether goods were received or services were provided before or after June 30 and report them appropriately as liabilities or encumbrances.

Item 4. Inadequate Support for Amounts Due From Other Funds

Finding: The General Fund Due From Other Funds account balance totaled approximately \$2.7 million at June 30, 1985. The board was unable to provide a detailed listing for approximately \$2 million of the \$2.7 million total. Therefore, we could not verify the Due From Other Funds account balance without reconstructing the balance ourselves.

Criteria: State Administrative Manual Section 7951 requires agencies to retain "detail to support general ledger account balances as of June 30 for use by auditors of the Department of Finance and the Auditor General." Also, good internal control requires the periodic reconciliation of subsidiary records with the associated control account in the general ledger, thus assuring the detection of errors and the fair statement of the account balance.

Recommendation: The board should ensure that a detail listing of amounts due from other funds is available to support the financial statements. Also, the board should reconcile its detail listing to the control account balance in the General Ledger.

Item 5. **Inadequate Documentation of the EDP Apportionment System**

Finding: The board has not adequately documented the EDP system that apportions approximately \$1.1 billion of state funds annually to the community colleges. Insufficient documentation exists for planning and testing the EDP system and programs, for programming changes resulting from statutory requirements, and for the creation and maintenance of such system and programs. Without adequate documentation, no basis exists to determine that the system is working as intended. In January 1986, the board started to implement procedures to develop and maintain adequate documentation of its EDP system and programs.

Criteria: Effective internal control over EDP activities requires that evidence of controls over system design, development, testing, and changes of the EDP system and programs exists.

Recommendation: The board should continue to determine, establish, and ensure compliance with requirements for appropriate documentation of the EDP apportionment system.

Item 6. **Inadequate Separation of Duties in the Accounting and Budget Section**

Finding: The board does not provide adequate separation of duties in its Accounting and Budget Section. One employee prepares and reviews invoices, maintains the invoice and disbursement registers, maintains the general and receivable ledgers, and reconciles the bank statement. The board's fiscal officer attributes the inadequate separation of duties to understaffing in the Accounting and Budget Section. Unless such duties are properly segregated, an employee can conceal irregularities, and responsibility for errors may not be determined.

Criteria: State Administrative Manual Sections 8080 to 8080.2 prescribe separation of duties for agencies whose accounting systems include manual and automated processes. These sections specify that an employee who initiates or prepares invoices is not to reconcile bank accounts and post to the general ledger or any subsidiary ledger affected by cash transactions. In addition, an employee who initiates or prepares invoices is not to keep more than one of the following books of original entry:

General Cash Receipts Register, General Cash Disbursements Register, Trust Fund Cash Receipts Register, Trust Fund Cash Disbursements Register, Revolving Fund Cash Book, and Invoice Register.

Recommendation: The board should reassign duties among employees in the Accounting and Budget Section to provide the separation of duties required by State Administrative Manual Sections 8080 to 8080.2.

Item 7. **Inadequate Billing and Collection Procedures**

Finding: The board has not established an adequate billing, collection, and accounting program for accounts receivables related to its vocational education projects. The board's accounting personnel do not rely on the project expenditure balances to be billed as indicated on the CALSTARS Project Billing Activity Report because this report includes inaccurate expenditure balances to be billed. Also, accounting personnel do not reconcile the totals from the subsidiary receivable ledgers (CALSTARS Project Billing Activity Report) to the general ledger control account balance. As a result, the board has not billed the State Department of Education \$366,000 for fiscal year 1984-85 project expenditures related to completed vocational education contracts. In addition, the board has not collected \$629,000 from the State Department of Education for project expenditures related to prior year vocational education contracts.

Criteria: State Administrative Manual Section 8776.3 requires agencies to prepare and send out an invoice or other type of claim document as soon as possible after the recognition of a claim. Also, State Administrative Manual Section 8710.1 requires agencies to develop collection procedures that will assure prompt follow-up when payments are not received. Finally, good accounting control for accounts receivables requires accurate and timely recordkeeping to reflect accurate amounts receivable.

Recommendation: The board should develop and maintain adequate billing, collection, and accounting procedures that will ensure the prompt and accurate billing, recovery, and recordkeeping of vocational education funds from the State Department of Education.

Item 8.

Inadequate Controls Over Property

Finding:

As we reported for the last two years, the board has not reconciled its physical inventory of property to its accounting records within the last three years. In February 1983, the board's headquarters were severely damaged by fire. Currently, the board is comparing the property records of the physical inventory completed in February 1985 to the property records it had prior to the February 1983 fire. This lack of control over property can result in loss of state property.

Criteria:

State Administrative Manual Section 8659 requires that a physical inventory of property be reconciled to accounting records at least once every three years.

Recommendation:

The board should complete its comparison of its 1983 and 1985 physical inventory records and reconcile its property records to its accounting records.

CALIFORNIA STATE UNIVERSITY

Item 1. Inadequate Control Over Receipt of and Payment for Goods and Services

Finding: San Jose State University does not provide adequate internal accounting control over the receipt of and payment for goods and services. The university does not always verify that billed goods and services have been received before it pays for them. Therefore, it is possible that payments are being made for goods or services that the university has not received.

Criteria: State Administrative Manual Sections 8410 and 8422.1 require agencies to prepare stock-received reports and to determine that goods or services have been received before payment is made for them.

Recommendation: San Jose State University should prepare stock-received reports and determine that goods and services have been received before making payments for them.

Item 2. Inaccurate Identification of Obligations

Finding: The accounting personnel of CSU Sacramento and San Jose State University did not accurately identify in their financial statements which of their unliquidated encumbrances constituted obligations at June 30, 1985. Also, San Jose State University did not include all unliquidated encumbrances and obligations in its year-end financial statements. As a result, CSU Sacramento and San Jose State University reported to the State Controller's office incorrect amounts for obligations, unliquidated encumbrances, and expenditures. San Jose State University misclassified \$224,000 of its obligations as encumbrances. In addition, its obligations and expenditures were understated by \$314,000. CSU Sacramento overstated encumbrances by \$169,000 and understated obligations by \$313,000, resulting in net understated expenditures of \$144,000.

Criteria: State Administrative Manual Section 10584 states that all encumbrances unliquidated as of June 30 be reviewed to determine whether they are valid obligations of the year ended and whether the amounts encumbered are the most accurate that can be determined.

Recommendation: The CSU Sacramento and San Jose State University accounting personnel should accurately identify which of their unliquidated encumbrances are obligations at June 30. Also, San Jose State University should include all unliquidated encumbrances in its year-end financial reports.

Item 3. **Inadequate Control Over Cash Change Funds**

Finding: CSU Sacramento maintains 50 cash change funds that total \$10,390 and are held in various locations. Fifteen of these funds are over \$200 in amount. Of the three largest funds, two are \$1,000 each and one is \$2,250. None of these cash change funds are independently counted by employees other than the custodians of the funds.

Criteria: State Administrative Manual Section 8111.2 requires that cash change funds of \$200 or less be independently counted annually and that cash change funds of larger amounts be counted more than once a year.

Recommendation: CSU Sacramento should ensure that cash change funds be independently counted in accordance with the requirements of State Administrative Manual Section 8111.2.

Item 4. **Inadequate Certification of Payroll Claims**

Finding: CSU Sacramento payroll claims are certified by payroll clerks but are not reviewed and certified by a duly appointed, qualified, and acting officer of the university. The certification is to ensure, among other things, that the payroll is correct; that the work was actually performed for the benefit of the State; that the payments are for the named individuals and that they were employed in accordance with the law; that all the provisions of law governing such employment have been fully complied with; and that all deductions for purposes set forth in the Government Code are in conformity with written authorization of the employees. Because of the significance of the certification, it is required that an officer of the university make the certification.

Criteria: California Administrative Code, Title 2, Division 2, Chapter 1, State Board of Control, Section 654, requires that each payroll claim contain a certification from a duly appointed, qualified, and acting officer of the state agency.

Recommendation: CSU Sacramento should require that all payroll claims prepared by the payroll clerks be reviewed and certified by a responsible officer of the university before submitting them to the State Controller for processing.

Item 5. **Unreported Employee Expense Advances**

Finding: CSU Sacramento did not report salary and travel advances totaling approximately \$144,000 in its year-end financial reports. The advances were incorrectly reported as revolving fund expenditures not scheduled for reimbursement by June 30, 1985, and were later deducted from the balance of accounts payable. As a result, both advances and payables were understated. These errors were not detected when the financial statements were approved by CSU Sacramento administrative personnel.

Criteria: State Administrative Manual Section 10420 requires that employee salary and travel advances outstanding at June 30, 1985, be reported as advances due from employees in year-end financial reports.

Recommendation: The administrative personnel of CSU Sacramento should ensure that the year-end financial reports are accurate before approving them for distribution.

CALIFORNIA STUDENT AID COMMISSION

The California Student Aid Commission administers one of the 34 federal programs we reviewed. It is the U.S. Department of Education grant, Federal Catalog Number 84.032.

Item 1. Insufficient Controls Over Service Contractor

Finding:

The commission contracts for the data processing services related to student loans. However, the commission does not sufficiently control its service contractor, the E.D.S. Corporation (E.D.S.). As a result, the commission was unaware of two changes that the E.D.S. made in its computer programs. These changes affected the E.D.S.'s accumulation of information for the federal quarterly reports and the billing for services; both changes were adverse to the commission. Also, the commission does not require the E.D.S. to provide detailed support for its computer-generated reports. Because the commission cannot compare the reports to the underlying data and does not use other means to check the reports, it cannot ascertain their accuracy.

The E.D.S. made the first program change in early 1984. The purpose of the change was to correct an error in the system. However, in making this change, the E.D.S. inadvertently created errors in the cumulative data that the commission used in filing federal quarterly reports. Because of these report errors, the United States Department of Education did not reimburse the commission for administrative costs for the December 1983 and subsequent quarters until the commission submitted accurate reports. As a result, the commission did not receive reimbursement for administrative costs for the December 1983 quarter until May 1985, and it did not receive reimbursement for the March, June, and September 1984 quarters until October 1985. We estimate that the State Guaranteed Loan Reserve Fund lost approximately \$350,000 in interest revenue that the fund would have earned during the fiscal year 1984-85 if the commission had submitted correct reports on time.

The commission continued to have difficulties in filing correct federal quarterly reports on time. However, the delay in the December 1984 to June 1985 quarterly filings did not have a financial impact because the United States Department of Education,

for budgetary reasons, suspended reimbursements of administrative costs to guarantee agencies for the federal fiscal year that began in October 1984.

The E.D.S. made a second program change in March 1985. The program change allowed the system to include, for processing and billing purposes, records that the program previously ignored because they were inactive or potentially duplicative. The E.D.S. did not notify the commission of this change. While the change did not materially increase the E.D.S.'s service charges to the commission, the commission's lack of awareness of the change indicates a weakness in the commission's monitoring of its service contractor.

In addition to not adequately monitoring its service contractor's programming and reporting activities, the commission does not require the E.D.S. to provide detailed support for computer generated reports. Because the commission does not have adequate procedures to verify or reconcile the reports to accounting data and other existing information, it has no assurance that the reports are accurate. In our test of the June 1985 student loan master file, we found that the file did not support the monthly activity reports for June and the related invoice, both of which are generated from the master file. The E.D.S. had to prepare two additional sets of tapes of the master file to be able to support the amended June reports. We also identified errors in the August 1984 and March 1985 monthly reports and invoices that the commission and the E.D.S. had not detected. As a result of these errors and the program change in March 1985, the E.D.S. overcharged the commission \$2,700 in contract fees.

Because the E.D.S. computer files generate part of the financial information for the State Guaranteed Loan Reserve Fund and determine the service costs charged to the fund, it is critical that the computer files and the reports generated from the files are accurate and fully supportable. The commission is responsible for ensuring the integrity of the files. However, under its current service contract, the commission has not been able to meet this responsibility because the contract does not provide for penalties for inadequate performance.

Criteria: Federal quarterly reports for the guaranteed student loan programs must be filed no later than 60 days after the close of each quarter. Also, the Office

of Management and Budget Circular A-128 requires that federal reports contain accurate and reliable financial data. Non-compliance with federal reporting requirements could result in the federal government's taking action against the guaranteed student loan programs that the commission administers.

Recommendation: The commission should actively monitor the data and reports compiled by its service contractor. The commission should either require detailed support for the monthly invoices for service fees, or it should regularly audit the processing of the data. The commission should also reconcile the E.D.S. reports to other existing information. In any future service contract, the commission should stipulate the penalties that the contractor incurs for not producing correct reports on schedule, especially when a delay causes financial losses to the State Guaranteed Loan Reserve Fund.

Item 2.

Inaccurate Financial Statements

Finding: The commission did not prepare accurate financial statements for the State Guaranteed Loan Reserve Fund for the fiscal year ended June 30, 1985. As a result of inadequate year-end accrual and insufficient review procedures, balances for various liability and revenue accounts were misstated. Specifically, the accounting staff did not prepare an accurate detailed list to support the balance of accounts payable. We found the list to be incomplete, and some items on the list were not fully supported. Our test showed that the accounts payable balance was understated by \$12,145. According to State Administrative Manual Section 10584, the balance of accounts payable must be supported by a detailed list of all valid obligations payable at June 30.

Furthermore, the commission does not have procedures to ensure that all revenues are recognized in the proper accounting period. For example, recoveries on defaulted student loans were made through the Franchise Tax Board offset program in the latter part of June but were not recognized in the financial statements for the year ended June 30; therefore, assets were understated by \$73,500, and liabilities and revenues were understated by \$51,500 and \$22,000, respectively. Additionally, the commission did not recognize all revenue from insurance premiums related to the 1984-85 fiscal

funds could be misused when persons authorized to sign checks have unsupervised access to the blank check stock.

Criteria: State Administrative Manual Sections 8024 and 8080, respectively, state that the combination to safes be known to as few persons as possible and that persons who sign checks not have access to the blank check stock.

Recommendation: The commission should restrict access to the safe to two or three individuals. In addition, an individual who has access to the safe and thus to the blank check stock should not have the authority to sign checks.

Item 4. **Lack of Two Signatures on Large Checks**

Finding: We found that five checks paid to the E.D.S. had only one signature although the amounts exceeded \$15,000. One of the five checks was for more than \$600,000. The commission did not have a special waiver from the Department of Finance. Accounting personnel stated that they were not aware of the dual signature requirement. The lack of adherence to the requirement increases the risk that large amounts of money will be disbursed improperly.

Criteria: State Administrative Manual Section 8001.2 requires that all checks in excess of \$15,000 have two authorizing signatures, unless the payee is a specified state agency or the commission has obtained written authorization from the Department of Finance to deviate from this requirement.

Recommendation: The commission should adhere to State Administrative Manual Section 8001.2 by requiring two authorized signatures on all checks over \$15,000, unless the payee is a state agency, or it should request a waiver of the requirement from the Department of Finance.

Item 5. **Inadequate Attendance and Leave Records**

Finding: During our testing of personal services expenditures, we found errors in the calculation and posting of earned and used leave hours. In addition, not all leave taken was properly supported by the required absence reports. We tested a sample of sixteen monthly payroll transactions and found that, in two instances, employees' leaves indicated

on the absence reports were not properly charged to their leave records, resulting in overstated leave balances. In the same sample, we identified two more errors in recording the monthly earned vacation hours on the leave cards. In two additional cases, the absence reports supporting the leave taken did not agree with the unit attendance reports. Our further investigation of these discrepancies revealed that the errors could be attributed to a particular time period and to one particular employee who performed these clerical tasks. This employee no longer works for the commission.

Criteria: Management is responsible for establishing a system of internal accounting control. An essential element of such a system is the proper supervision of employees and the monthly reconciliation of related accounting records. Also, Personnel Transactions Manual Section 615 requires the accurate use of the monthly attendance reports, absence request forms, and employee leave records.

Recommendation: The commission should require supervisors to periodically review the work of their staffs and give special attention to new or inexperienced staff. Specifically, leave cards of all active commission employees should be reviewed to ensure that balances calculated for a given period are correct. Also, all related attendance and leave reports should be reconciled monthly.

Item 6. **Insufficient Controls Over Equipment**

Finding: We reviewed the records and verified the existence of items on the equipment list of the State Guaranteed Loan Reserve Fund. We found that not all equipment is properly checked out to individuals responsible for those items and that the records of some equipment that had been moved or retired were inaccurate. We had difficulty in locating four of ten items that we selected for testing specifically because they were portable or highly desirable. Although commission personnel eventually located three of the four items, and the fourth item was a piece of obsolete equipment that was no longer in use, our test indicated that the records of accountability were incomplete and out of date.

Criteria: State Administrative Manual Section 8652.4 requires that control be maintained of all highly desirable and portable property by assigning accountability for those items when they are in use.

Recommendation: The commission should update all equipment records and should assign accountability for sensitive property to persons who use the items. The commission should also implement procedures to more frequently review and reconcile property to the records. The procedures should also be followed during relocation or reorganization of various units within the commission.

Item 7. **Incorrect and Late Federal Quarterly Reports**

Finding: The commission's federal quarterly reports for June 30, 1985, which the commission filed in October, contained incorrect information. In August, the E.D.S. had to amend the June 1985 monthly report when it identified errors in the report. However, it did not make the necessary corrections in the records from which the federal reports are produced. As a result, the federal reports for the June quarter did not include the corrected data. The commission filed the corrected December 1984 and March 1985 quarterly reports, as well as the June 1985 quarterly reports, in October 1985.

Criteria: Federal regulations for the guaranteed student loan program require that accurate federal quarterly reports be filed within 60 days of the end of the quarter.

Recommendation: The commission should reconcile federal quarterly reports to the monthly reports and to those of preceding quarters and should file the federal reports on time. It should also ensure that the E.D.S. corrects its records retroactively.

DEPARTMENT OF CORRECTIONS

Item 1. Failure To Reconcile Cash in State Treasury Account With State Controller's Records

Finding: The department does not reconcile its Cash in State Treasury account for the New Prison Construction Fund to the records of the State Controller's office. Failure to reconcile this account may prevent the detection of errors in the cash account. For example, at June 30, 1985, the department's record of Cash in the State Treasury account for the New Prison Construction Fund was overstated by approximately \$8.6 million. This difference resulted because the department did not reduce its Cash in State Treasury account balance by approximately \$6.4 million for expenditures incurred in fiscal year 1982-83 and by \$2.2 million for transfers made to other funds in fiscal year 1983-84.

The department's accounting administrator stated that during fiscal years 1982-83 and 1983-84, the department unknowingly used incorrect account codes to record these expenditure transactions, thus creating a difference between the department's records and the State Controller's records. Although the department later became aware of its errors, it had not corrected them at the time of our review. Upon our request, the department prepared a reconciliation that identifies all items needed to reconcile the department's records of the Cash in State Treasury account for the New Prison Construction Fund with the State Controller's records and prepared accurate financial statements.

Criteria: State Administrative Manual Section 7910 stipulates that, at least at the end of each quarter, agencies accounting for a fund in its entirety should verify the balance in their Cash in State Treasury accounts with the matching account maintained by the State Controller's office.

Recommendation: The department should reconcile its Cash in State Treasury account for the New Prison Construction Fund to the State Controller's records quarterly. Additionally, the department should adjust its Cash in State Treasury account to reflect \$6.4 million in expenditures applicable to fiscal year 1982-83 and \$2.2 million in transfers to other funds applicable to fiscal year 1983-84.

Item 2.

Lost Vendor Discounts

Finding: The department's Contract Payment Unit does not always promptly pay invoices to take advantage of vendor discounts. As a consequence, the department lost approximately \$4,000 in vendor discounts on 34 vendor invoices because of late payments. Accounting personnel stated that payments on invoices are late partly because some correctional institutions do not promptly submit reports on stock they receive to headquarters.

Criteria: State Administrative Manual Section 8422.1 and Board of Control Rules Section 678 require state agencies to take all discounts when available. In addition, State Administrative Manual Section 8410 provides that the original report on stock received is to be forwarded to the agency's accounting office on the day the stock is received.

Recommendation: The department should require correctional institutions to prepare and submit reports on stock received on the day the stock is received and instruct the Contract Payment Unit to pay invoices promptly to receive available discounts.

Item 3.

Failure To Maintain Signature Card File

Finding: The department's Accounting Office does not maintain a signature card file or memo listing of persons authorized to approve construction payments to contractors. Therefore, the office cannot compare signatures on pay documents to signatures on file to prevent improper or unauthorized payments.

Criteria: Good internal controls require that a copy of the signature of each person authorized to approve payment be maintained and that a comparison of this signature to the payment documents be made to prevent improper or unauthorized payments.

Recommendation: The department's Accounting Office should maintain a memo listing and signature card file of each person authorized to approve construction payments. The office should compare signatures on pay documents to signatures on file to prevent improper or unauthorized payments.

Item 4.

Late Financial Statements

Finding:

As of November 25, 1985, the last scheduled day of our fieldwork, the department had not filed its year-end financial statements, due on August 20, 1985, with the State Controller for either the New Prison Construction Fund or the 1984 Prison Construction Fund. According to the department, this delay is partially due to difficulties in gathering information from correctional institutions. Agencies that submit financial statements late delay the State Controller in compiling complete financial statements for the State.

Criteria:

State Administrative Manual Section 7990 requires state agencies to submit year-end financial statements to the State Controller for funds other than the State's General Fund no later than August 20.

Recommendation:

The department should submit its year-end financial statements to the State Controller on time.

DEPARTMENT OF ECONOMIC OPPORTUNITY

The Department of Economic Opportunity administers 2 of the 34 federal programs we reviewed. They are the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 13.818 and 13.665.

Item 1. Imprudent Monitoring of Cash Advances

Finding: During fiscal year 1984-85, the department did not prudently monitor cash advances to its LIHEAP contractors. Although the department's senior accounting analyst reviews a contractor's expenditure report for reasonableness of expenditure projections before approving an advance, in several instances, this procedure was not followed, and contractors had excessive cash on hand. Specifically, we found that 4 contractors out of the 15 we tested had enough cash on hand to cover between four and ten months of average expenditures. Prudent monitoring of cash advances ensures that contractors do not receive cash advances that exceed their immediate cash needs.

Criteria: The U.S. Office of Management and Budget Circular A-102, Attachment G, requires that state financial management systems include procedures to minimize the time between the transfer of funds from the department and the use of those funds by the contractors.

Recommendation: The department should evaluate and monitor federal cash balances being held by LIHEAP contractors.

Item 2. The Annual Report for the LIHEAP Block Grant Was Late and Inaccurate

Finding: The annual report for the LIHEAP Block Grant was submitted five days late, and certain financial information in the report did not agree with the department's financial records. We also reported in our audit for fiscal year 1983-84 that this annual report was submitted late. In its response to our report, the department stated it would submit its annual report for the 1984-85 federal fiscal year by October 31, 1985.

Criteria: Code of Federal Regulations, Title 45, Section 96.82, governing the LIHEAP Block Grant requires each state receiving funds to submit, by October 31 of each year, a report on the number and income level of all households assisted by the funds during the preceding federal fiscal year. Also, the Office of Management and Budget Circular A-102, Attachment G, requires that grantee financial management systems provide accurate, current, and complete disclosure of the financial results of grant programs.

Recommendation: The department should ensure that the annual report is submitted to the federal government by October 31 of each year and that the report data agree with the department's financial records.

Item 3. **Lack of Standardized Monitoring Procedures for the LIHEAP and the CSBG Program**

Finding: The monitoring questionnaires that the department uses to evaluate the LIHEAP and the CSBG program do not include all of the criteria necessary to test the LIHEAP and CSBG contractors for compliance with federal guidelines established for their respective programs. Also, the monitoring process used by the department to evaluate the LIHEAP and CSBG program activities does not culminate in a standardized report that assesses the contractor's compliance with the federal requirements applicable to the contract. If the department does not use a monitoring questionnaire that includes all federal criteria that apply to the contracts and if it does not issue standardized monitoring reports addressing all of the federal criteria, the potential exists that significant program weaknesses could occur and remain undetected until an audit is performed.

Criteria: Public Law 97-35, Section 675(c)(9) and Section 2605(b)(10), require that fiscal control and fund accounting procedures be established as necessary to ensure the proper disbursement of, and accounting for, federal funds paid to the State under these block grants, including procedures for monitoring the assistance provided.

Recommendation: The department should develop a complete monitoring questionnaire for both the LIHEAP and the CSBG program. These questionnaires should address all

pertinent federal compliance criteria and result in monitoring reports consistent with the elements evaluated in the questionnaires.

Item 4. **Appeal Decisions Are Not Promptly Communicated**

Finding: The department does not promptly communicate its decision to applicants appealing the denial of benefits under the Home Energy Assistance Program (HEAP). During our review of the HEAP, we noted that there was a backlog of appeal decisions for fiscal year 1983-84 applicants who were denied services. The decisions on these applicants' appeals were not mailed to the applicants until November 18, 1985. By not informing applicants of appeal decisions promptly, the department may have hindered these applicants from seeking a fair hearing.

Criteria: Public Law 97-35, Section 2605(b)(13), requires that households that are denied assistance or do not receive prompt assistance have an opportunity for a hearing. Additionally, good program management requires that an organization promptly inform applicants whether or not they qualify for the services of the program.

Recommendation: The department should implement schedules to ensure that HEAP applicants who are appealing a denial of a benefits decision are notified promptly. In addition, the department should initiate procedures that will allow it to meet the prescribed deadlines.

Item 5. **Overpayment in the Home Energy Assistance Program**

Finding: During the 1984-85 fiscal year, the HEAP made an overpayment of approximately \$130 in federal funds to one of its participants. The HEAP utilizes the services of the Franchise Tax Board to process data from HEAP application forms. The forms are then further processed using the HEAP's computer. Due in part to the poor design of the HEAP application form, the Franchise Tax Board entered the monthly income as "annual income" on one HEAP applicant's form. As a result of this error, the HEAP authorized a payment of approximately \$130 more in federal assistance than it should have.

Criteria: Public Law 97-35, Section 2605(b)(10), requires that fiscal control and fund accounting procedures be established as necessary to ensure the proper disbursement of and accounting for federal funds paid to the State under this block grant.

Recommendation: The department should redesign its HEAP application form to make it easier for applicants to understand and complete. The department should also initiate verification procedures on the data processed by the Franchise Tax Board.

Item 6. **The Department Did Not Include All Federal Requirements In Its Energy Crisis Intervention Program Contracts**

Finding: The 1984-85 contract for the Emergency Crisis Intervention Program (ECIP) under the LIHEAP Block Grant does not contain any provisions regarding the federal requirement that the State notify recipient households when assistance is paid directly to an energy supplier on their behalf. The department's failure to include this federal requirement in ECIP contracts reduces the assurance that contractors are providing this notification.

Criteria: Public Law 97-35, Section 2605(b)(7)(A), requires that if the State chooses to pay home energy suppliers directly, procedures be established to notify each participating household of the amount of assistance paid on its behalf. Good program management requires the State to have similar control over contractors when contractors make direct payments on behalf of the State to home energy suppliers.

Recommendation: The department should include in future ECIP contracts the federal requirement that notification be given to recipient households of any payments made to energy suppliers on the recipients' behalf.

Item 7. **The Department Failed To Use at Least 90 Percent of Its 1983-84 Federal Fiscal Year CSBG Allotment To Make Grants to Qualified Agencies**

Finding: The department used only 89.4 percent of its 1983-84 CSBG allotment for grants to qualified organizations instead of the federally required 90 percent minimum. The department contends that it has met the 90 percent minimum by using 1982-83 CSBG carry-over funds. However, we believe that federal

law requires the 90 percent allocation to be made from each year's allocation.

Criteria: Title 42, U.S.C. Section 9904, requires that not less than 90 percent of the funds allotted to the State under the CSBG be used to make grants to qualified organizations.

Recommendation: The department should use at least 90 percent of each year's CSBG allocation to make grants to qualified organizations.

STATE DEPARTMENT OF EDUCATION

The Department of Education administers 8 of the 34 federal programs we reviewed. They are the U.S. Department of Agriculture grants, Federal Catalog Numbers 10.553, 10.555, and 10.558, and the U.S. Department of Education grants, Federal Catalog Numbers 84.010, 84.011, 84.027, 84.048, and 84.151.

Item 1. Late Financial Reports

Finding: The department did not submit its financial reports to the State Controller until September 17, 1985. Although the financial reports were submitted approximately one month earlier than they were submitted last year, they were still over one month late. The department's accounting staff contend that the logistics of entering a large agency's data into the CALSTARS makes it impossible to meet the deadlines required by the State Controller's office. Failure to submit final financial reports when they are due delays the State Controller's compilation of financial statements for the State of California.

Criteria: State Controller's memorandum dated May 24, 1985, requires multi-funded agencies to submit their General Fund financial reports by July 31. Financial reports for funds other than the General Fund must be submitted by August 20.

Recommendation: The department, the Department of Finance, and the State Controller's office should work together to ensure that the department accomplishes its year-end closing on time.

Item 2. Failure To Reconcile State School Fund With General Fund

Finding: The department did not reconcile State School Fund expenditures of \$8.9 billion to General Fund appropriations. We observed this same weakness in fiscal year 1983-84. Further, the department's Local Assistance Bureau (bureau) did not provide instructions to the State Controller's office on how to record prior year apportionment adjustments. Consequently, the State Controller's office incorrectly recorded adjustments to prior year apportionments in current year appropriations; as a result, it appeared that current year appropriations had funds available for accrual. Since the department's accounting office did not reconcile the

office used funds that the department's bureau had designated for the Adult Education Program. In addition, both the accounting office and the bureau assumed that the State Controller's balances were correct at June 30, 1985, and inappropriately accrued a \$9.5 million liability, as discussed in Item 2.

Criteria: Government Code Section 13403 requires the elements of a satisfactory system of internal accounting control to include, but not be limited to the following:

1. A system of authorization and recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures.
2. An established system of practices to be followed in performance of duties and functions in each of the state agencies.

Recommendation: The department and the State Controller's office should come to an agreement as to which single agency is to maintain the responsibility for accounting for the State School Fund. The selected agency should prepare all journal entries, transfer documents, and reconciliations.

Item 4. Incorrect Calculation of Entitlements for the School Improvement Program

Finding: The Local Assistance Bureau did not calculate the School Improvement Program entitlements for fiscal year 1984-85 in accordance with state statutes. The bureau gave those school districts that were disallowed a cost of living adjustment, as determined by Education Code Section 52048, the same amount of funding that they received in fiscal year 1983-84. However, according to our legal counsel's interpretation of the Education Code, the bureau should have based its calculations of the School Improvement Program funding for fiscal year 1984-85 on Education Code Sections 52046(b)(1) and (2), which adjust the previous year's funding by the student attendance figures. The department's legislative coordinator noted that Item 6100-116-001(4) of the Budget Act of 1984 directs the department to promote the legislative intent to equalize the School Improvement Program funding as specified in Education Code Section 52048 and, therefore, the department assumed that

Education Code Sections 52046(b)(1) and (2) were no longer in effect. If the department maintains district entitlements at the fiscal year 1983-84 funding level, school districts whose student attendance figures increase or decrease from year to year would not be granted a corresponding increase or decrease in the entitlement.

Criteria:

Education Code Sections 52046(b)(1) and (2) require that from funds appropriated, the superintendent is to make allowances to schools with approved school improvement plans through implementation grants in the following amounts:

1. \$148 per unit of average daily attendance in kindergarten and grades 1, 2, and 3, or their equivalent, exclusive of average daily attendance in summer school.
2. \$90 per unit of average daily attendance in grades 4 to 8, inclusive, or their equivalent, exclusive of average daily attendance of summer school, regional occupational centers and programs, and adult classes by regular high school pupils.

Recommendation:

The department should follow Education Code Section 52046(b)(1) and (2). If the department believes that Education Code Section 52046(b)(1) and (2) no longer reflects legislative intent, the department should ask the Legislature to revise the Education Code.

Item 5.

Inadequate Approval for CALSTARS Override Function

Finding:

The department's accounting office personnel do not always request or justify the use of fund control overrides. We observed a similar weakness in fiscal years 1982-83 and 1983-84. A fund control error occurs when the posting of an accounting transaction causes a violation of a controlled amount in the appropriate CALSTARS masterfiles. The department's Fiscal Systems Operations unit instituted a procedure, effective July 2, 1984, requiring users to complete an override request with justifications and supervisory approvals to document fund control overrides. We found that 46 of 76 error messages we reviewed were cleared through the use of overrides. The Fiscal Systems Operations unit performed 11 of the 46 overrides without the proper authorizing form. Users indicated a need for the overrides on the error correction reports but did not justify

this need for 7 of these overrides. When the proper authorization and justification process is not used, the department minimizes the effectiveness of the fund control edits.

Criteria: The department's Fiscal Systems Operations unit issued a memorandum on June 28, 1984, to accounting office personnel stating that as of July 2, 1984, a form is to be completed by supervisors or other preparers authorizing fund control overrides for all fiscal year 1984-85 transactions.

Recommendation: The department's Fiscal Systems Operations unit should not enter overrides unless the overrides are properly authorized and justified in accordance with the procedure instituted on July 2, 1984.

Item 6. Inadequate Control Over Changes Made to CALSTARS Tables

Finding: Department personnel initiating changes to CALSTARS tables do not post the changes to the "table maintenance log" (the department's record of changes made to the CALSTARS tables). We observed this same weakness in fiscal year 1983-84. For example, the department's budget office submits input documents for funding changes to the Fiscal Systems Operations unit. The Fiscal Systems Operations unit records entries in the table maintenance log at the time the funding changes are entered into the system. No record of the entries exists from the time of preparation by the budget office to the time that the funding changes are entered into the system. Further, the department does not reconcile activity reports, which reflect the processing of the input documents, to the table maintenance log. These two deficiencies minimize the control that the table maintenance log provides over changes to the CALSTARS tables.

Criteria: The CALSTARS Procedures Manual states that the various activity reports must be reconciled to the table maintenance log to ensure that each table was properly updated. Good internal control requires accounting entries to be controlled from the time the changes are initiated.

Recommendation: The department should ensure that each unit initiating changes to the CALSTARS tables posts the changes to the table maintenance log. Each unit should then turn in its log to the Fiscal Systems Operations unit at the end of each day. The Fiscal

Systems Operations unit should periodically reconcile the table maintenance log to the activity reports.

Item 7. **Inadequate Documentation of Postings to the CALSTARS Labor Distribution Subsystem**

Finding: The department's Time Accounting unit did not prepare adequate documentation in support of selected postings to the CALSTARS Labor Distribution subsystem during fiscal year 1984-85. Of the 50 payroll transactions that we reviewed, we found that documentation for two manual entries was incomplete. Additionally, the department did not prepare explanatory documentation and corrections for four adjusting entries. Furthermore, the department had not corrected the four adjusting entries as of June 30, 1985. If the department does not maintain adequate documentation, we are not able to conclude that the CALSTARS Labor Distribution subsystem is properly allocating personnel costs.

Criteria: Government Code Section 13403 establishes as one element of a satisfactory system of internal accounting control a system of authorization and recordkeeping that is adequate for the performance of duties and functions in each of the state agencies.

Recommendation: The department's Time Accounting unit should prepare adequate documentation for all CALSTARS Labor Distribution subsystem entries.

Item 8. **Inadequate Collection Procedures**

Finding: The department's accounts receivable collection procedures do not ensure that Child Development program receivables are collected promptly. We observed this same weakness in fiscal year 1983-84. We reviewed 31 delinquent Child Development program receivables totaling \$1,662,610. We found the department had submitted 6 of the 31 invoices to the Board of Control for write-off approval, and another 8 were involved in litigation proceedings. However, the Child Development Division had not performed any significant collection activities on the remaining 17 invoices. As a result, we believe that the department will not be able to collect approximately \$1,370,000 of these receivables.

In addition, the department's accounts receivable procedures include the monthly mailing of notices of overdue accounts for Child Development invoices. The department's accounting staff mailed these notices only four times during fiscal year 1984-85. According to the acting fiscal manager, Child Development Division, the notices of overdue accounts are an integral part of the Child Development collection procedures. The Child Development Division staff do not feel that they can perform collection procedures that involve contacting the delinquent sponsors unless the accounting office has been consistent in mailing the notices.

Criteria: State Administrative Manual Section 8710.1 requires agencies to "develop collection procedures which will assure prompt follow-up on receivables." Both the Child Development Division and the accounting office are responsible for Child Development program collections.

Recommendation: The department's Child Development Division should establish collection procedures that will ensure prompt follow-up on delinquent invoices. The accounting office should also mail notices of overdue accounts at least once a month.

Item 9. **Noncompliance With the Independence Standard of the Institute of Internal Auditors, Inc.**

Finding: Under the department's present organizational structure, the chief of the Management Review unit has authority over the Internal Management Audits and the Management Analysis sections. The purpose of the Management Analysis section is to help operating units correct deficiencies identified in audits performed by the Internal Management Audits section. If the sections are not independent of each other, the chief of the Management Review unit could restrict the presentation of conflicting information or otherwise inhibit the objectivity of the internal auditors.

Criteria: Government Code Section 1236 requires state agencies that conduct internal auditing activities to use the "Standards for The Professional Practice of Internal Auditing," of the Institute of Internal Auditors, Inc. Standard 110.01.1 states that "the director of the internal auditing department should be responsible to an individual with sufficient authority to promote independence and to ensure

broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations."

Recommendation: The department should comply with the Government Code and the standards for internal auditors by having the supervisor of Internal Management Audits report directly to the assistant superintendent for the Executive Planning and Review office.

Item 10. **Inadequate Documentation of Audit Findings and Recommendations by the Internal Management Audit Section**

Finding: The department's Internal Management Audits section's workpapers did not provide enough information to support audit findings and recommendations or to comply with the Institute of Internal Auditors. The Internal Management Audits section did not have all the workpapers available to document many of the findings in one section of its report entitled "Review of the System of Internal Accounting Control and Fiscal Procedures." The Internal Management Audits section's auditors did not adequately document their sources of information, audit methodologies, analyses, and conclusions in the workpapers and did not always include the purpose, auditor initials, date, tickmark legend, or evidence of supervisory review. Without proper documentation, the Internal Management Audits section is not assured that it has appropriately studied and reviewed all items reported. The validity of the information can be questioned when its source is unknown.

Criteria: Government Code Section 1236 requires state agencies that conduct internal auditing activities to use the "Standards for The Professional Practice of Internal Auditing," of the Institute of Internal Auditors. Standard 420.01.5 states that auditors should document the information they obtained in their analysis in the workpapers. This section also requires workpapers to support the findings and recommendations that the auditors report. In addition, Standard 230.03 requires that appropriate evidence of supervision be documented and retained.

Recommendation: The department should require the Internal Management Audits section to comply with the standards related to workpaper preparation. In addition, the supervisor should provide evidence of supervisory review to ensure that audit work and audit workpapers conform to standards.

Item 11.

Inadequate Internal Controls Over Property

Finding:

The department's internal controls over property are not adequate in the areas of separation of duties, physical count of inventory, and property management. The property clerk takes the inventory count and also maintains all inventory records. In addition, the department's Business Services office did not complete the last physical inventory cycle within the required three years. Instead, it took approximately five years. Finally, the department has not designated one officer or employee from each unit of the agency to be responsible for the property and equipment within his or her unit. The lack of adequate controls over property could result in a loss of assets to the State. The department accounts for approximately \$4 million in property.

Criteria:

State Administrative Manual Section 8659 requires the agency to assign a responsible person, other than the custodian of the property records, to take the inventory at least once every three years. State Administrative Manual Section 8651 requires the agency to designate one officer or employee of each unit to be responsible for property and equipment. This designation should be in writing and should indicate the person or position so designated, his or her area of responsibility, and the effective date.

Recommendation:

The department should assign an employee outside of the property unit the responsibility of conducting the inventory count. The department's Business Services office should conduct an inventory count at least once every three years. The department's Business Services office should assign a person in each unit the responsibility of property management.

Item 12.

Inadequate Controls Over and Accountability for the Revolving Fund

Finding:

The department does not maintain adequate controls over and accountability for the revolving fund. We observed similar weaknesses over the revolving fund controls in fiscal year 1983-84. The department overdrew the revolving fund 10 months out of 12 in fiscal year 1984-85. Also, the department's accounting staff did not prepare the monthly revolving fund accountability statement for any month during fiscal year 1984-85 except for the year-end statement. In addition, someone other than the custodian has not counted the revolving fund's

change funds on a regular basis. Finally, the person whose signature is used on revolving fund checks does not control the check-signing machine key, as required. Instead, the machine operator controls the key. Failure to adequately maintain control over and accountability for revolving fund activities can result in the misstatement of cash balances and prevent the early detection of irregularities such as unauthorized or excessive disbursements.

Criteria: The State's accounting system places dollar limitations on revolving funds to limit the potential loss of state funds. State Administrative Manual Section 8193 requires agencies to prepare reconciliations of the revolving fund account at the end of each month. State Administrative Manual Section 8111.2 requires an employee other than the custodian of the change fund to count it at least annually. State Administrative Manual Section 8081 requires the person whose signature is used on revolving fund checks to control the check-signing machine key. If the person whose signature is used is unavailable, the control of the key should be assigned to a responsible person other than the operator of the check-signing machine.

Recommendation: The department should maintain adequate controls over its revolving fund cash. Specifically, the department should conduct an evaluation of its system of reimbursing the revolving fund and determine if it is adequate, prepare monthly accountability statements, conduct change fund counts at least annually, and prohibit the operator of the check-signing machine from controlling the signature key.

Item 13. Late Scheduling of Claims To Reimburse the Revolving Fund

Finding: The department had not scheduled claims to reimburse the revolving fund for approximately \$340,000 in expense advances as of June 30, 1985. Three months later, it still had not scheduled claims to reimburse \$167,000 of this amount. In addition, the department incorrectly recorded approximately \$269,000 in reimbursements to expense advances under various incorrect vendor numbers and had not corrected them as of November 1985. We observed this same weakness in fiscal year 1983-84. The funds committed to these long-outstanding expense

advances are not available for use in the revolving fund, increasing the likelihood that the department will overdraw its revolving fund.

Criteria: State Administrative Manual Section 8170 provides the procedures that an agency should use to prepare claim schedules to reimburse the revolving fund. Good accounting procedures require the revolving fund to be reimbursed promptly.

Recommendation: The department should regularly review all expense advances to ensure that reimbursements have been made properly and promptly.

Item 14. **Late Deposit of Collections**

Finding: The department held a total of approximately \$280,000 in office revolving fund reimbursements from June 28, 1985, to July 31, 1985, before depositing it in the department's bank account. The department's failure to deposit reimbursements promptly resulted in approximately \$2,500 in lost interest to the State.

Criteria: State Administrative Manual Section 8030.1 stipulates that agencies deposit collections greater than \$5,000 on the day they are received unless they are received late in the day or there is another reason preventing their deposit. In these cases, the collections are to be deposited on the next working day. This section also stipulates that agencies not hold any undeposited collections longer than 15 working days.

Recommendation: The department should deposit collections on the day of receipt or on the next working day and should not hold undeposited collections for more than 15 working days.

Item 15. **Misstatement of Expenditures and Liabilities**

Finding: The department misstated its June 30, 1985, expenditures and liabilities for the Federal Trust Fund. Consequently, the Federal Trust Fund was overstated by approximately \$581,000.

We found the following specific errors:

1. The department overstated its Federal Trust Fund accruals by approximately \$100,000 because of an error in calculating the Vocational

Education Program accrual. The Vocational Education Program staff included in the accrual worksheet a contract that the department's accounting office staff had already accrued.

2. The department overstated its Federal Trust Fund accrual because it inappropriately accrued approximately \$115,000 for the Commodity Impoundment Recall. The department could not provide any documentation in support of this accrual.
3. The department overstated its Federal Trust Fund accrual by an additional amount of approximately \$366,000 because the department staff did not realize that it had already expended the federal Educationally Deprived Children--Local Educational Agencies' (Chapter One) funds at June 30, 1985.

Criteria: Government Code Section 13403 states that the elements of a satisfactory system of internal accounting and administrative control are to include a system of authorization and recordkeeping procedures adequate to provide effective accounting control over liabilities and expenditures.

Recommendation: The department should ensure that amounts accrued are as accurate as can be determined and that all amounts are properly documented.

Item 16. Insufficient Documentation of Federal Trust Fund Reconciliations

Finding: The department does not sufficiently document the Federal Trust Fund reconciliations between the department and the State Controller's office. The two reconciliations, one by appropriation and one by project, do not contain an adequate audit trail; therefore, we cannot verify that the department's balances reconcile with the balances of the State Controller's office. This lack of documentation occurs because a supervisor does not review the reconciliation to determine whether it is appropriately supported.

Criteria: State Administrative Manual Section 7900 states that regular reconciliations of agency accounts with matching accounts maintained in the State Controller's office partially insure the accuracy of financial reports. State Administrative Manual Section 7951 also requires agencies to retain detail to support General Ledger balances.

Recommendation: The department should include appropriate documentation of all amounts on the reconciliation to increase the reliance that the reconciliation is appropriately documented and decrease the time needed to verify that the reconciliation is correctly stated. An appropriate accounting supervisor should review the reconciliation.

Item 17.

Questionable Charges to Federal Grants

Finding:

Certain charges to federal grants during fiscal year 1984-85 were questionable. For 14 activities within four of the department's divisions, the department charged federal grants for administrative costs that were based on unsupported or poorly documented estimates. Further, department staff did not subsequently compare estimates to actual data to verify the reasonableness of the estimates. We noted the following specific deficiencies:

1. The department charged 10 percent (approximately \$400,000) of some of the Curriculum, Instruction, and Assessment Division's administrative costs for fiscal year 1984-85 to the Chapter One grant. The 10 percent was based on the department's undocumented estimate of the staff's workload for Chapter One activities. We observed this same weakness in fiscal year 1983-84. In response to our concerns in fiscal year 1983-84, the budget office subsequently requested the Curriculum, Instruction, and Assessment Division to justify its funding, but the division had not done so by completion of our fieldwork in January 1986.
2. Within the Vocational Education Division, the department charged approximately \$415,000 of the Vocational Education Consumer and Homemaking Education activities' administrative costs to the Vocational Education--Consumer and Homemaking Education grant. It based these costs on undocumented workload estimates. We observed this same weakness in fiscal year 1983-84.
3. The department charged approximately \$1,077,000 in administrative costs associated with the Compliance and Grants Management Division to the Chapter One grant based on a cost plan that was prepared using data from six years earlier. We observed this same weakness in fiscal year

1983-84. In response to our concerns in fiscal year 1983-84, the Compliance and Grants Management Division updated the cost plan using current data, and the budget office is using the updated plan in fiscal year 1985-86.

4. The department charged approximately \$50,000 of administrative costs associated with the Categorically Funded Programs unit to the Chapter One grant. It based these costs on undocumented workload estimates. The Categorically Funded Programs unit is in the process of documenting its workload for fiscal year 1985-86.

The manager of the Compensatory Education office and the administrator of the Vocational Education Grant Administration unit are preparing cost allocation plans for charges to the Chapter One grant and the Vocational Education grants, but they had not completed the plans by the time our fieldwork ended in January 1986.

Criteria:

Office of Management and Budget Circular A-102, Attachment P, requires that charges to federal awards be necessary and reasonable for the proper administration of the programs. In addition, Office of Management and Budget Circular A-87, Attachment A, requires a cost allocation plan "to support the distribution of any joint costs related to the grant program. All costs included in the plan will be supported by formal accounting records which will substantiate the propriety of eventual charges."

Recommendation:

The department should continue its efforts to charge the federal government based on actual data if possible. When estimates must be used, the budget office and program managers should coordinate their efforts to ensure that estimates are documented and reasonable.

Item 18.

Accruals in Excess of Federal Grant Authority

Finding:

As reported in fiscal year 1983-84, the department recorded expenditures in excess of federal grant awards for certain grant years. Because the department accrued revenue to match these expenditures, it recorded revenue accruals that exceeded legally available federal funds. The total of the grants tested showing excess accruals in fiscal year 1984-85 was approximately \$1.4 million.

In 1983-84, excess accruals were approximately \$18 million. In an attempt to resolve the apparent overexpenditures at June 30, 1984, during fiscal year 1984-85 the department's accounting office staff reviewed and adjusted many of the expenditures that they determined had been incorrectly recorded under a grant year. Since other grant years showed unused funds, the department resolved many of the overexpenditures we found in fiscal year 1983-84, reducing its overexpenditures from approximately \$18 million in fiscal year 1983-84 to approximately \$1.4 million in fiscal year 1984-85. However, the department's ability to adjust its expenditures between grant years may be limited because the U.S. Department of Education has questioned the propriety of adjusting expenditures after the 27-month period for which the grant is available. Therefore, the fiscal year 1984-85 revenue accruals for those grants that appear to be overexpended, as well as the department's adjustments to correct the fiscal year 1983-84 overexpenditures, may not be valid. The federal Education Appeal Board continues to review this issue.

Criteria: Proper grant management requires that each grant's expenditures not exceed the grant award available for each fiscal year.

Recommendation: To properly account for federal grants, the department should ensure that grant expenditures are recorded properly under each grant award. The department should identify any errors from previous years as soon as possible and should work with the U.S. Department of Education to determine the propriety of the department's method of adjusting expenditures.

Item 19. **Excessive Federal Funds on Hand**

Finding: The department's system of drawing down federal funds does not ensure that federal disbursements are limited to the department's immediate needs. We observed this same weakness in the draw down process in fiscal year 1983-84. We reviewed approximately \$606 million in federal funds drawn down to pay local assistance expenditures for federal programs. Of the \$606 million that we reviewed, approximately \$130 million was drawn down and held for periods of 11 to 34 days before the State disbursed the money. In some instances, the State Controller held claim schedules. In other instances, the department held claim schedules for reasons that we could not

determine. Maintaining "excessive cash" may result in the termination of advance financing from the federal government.

Criteria: Department of Treasury Circular 1075, Section 205.4(a), requires that "the timing and amount of cash advances shall be as close as is administratively feasible to the actual disbursements by the recipient organization."

Recommendation: The department should establish procedures to ensure that federal draw downs are limited to the department's immediate needs.

Item 20. Inaccurate Calculation of Drawdowns of Federal Funds

Finding: The department's process for determining the amount of federal funds to be drawn down for administrative costs of federal programs is not always accurate. We observed a similar weakness in the drawdown process for fiscal year 1983-84. We reviewed \$24.6 million in drawdowns for administrative costs. We found that the department's CALSTARS had reported \$813,000 more expenditures than the department used to calculate the drawdowns. Further, the department drew down \$1.22 million more funds than it should have based on its own calculations. As a result, \$407,000 (\$1.22 million - \$813,000) of the drawn down funds was not correctly calculated.

Criteria: Office of Management and Budget Circular A-102, Attachment G, requires recipients of federal funds to maintain records that accurately identify the source and application of the funds drawn down.

Recommendation: The department should exercise greater care when performing the calculations necessary to determine the amount of federal funds to be drawn down. This procedure should include a review by an appropriate person.

Item 21. Lack of Assurance That Local Educational Agencies Submit Their Audit Reports on Schedule

Finding: Twenty-eight out of 70 local educational agencies tested did not submit their fiscal year 1983-84 audit reports to the department's Audit Bureau before December 31, 1984, the final date by which local educational agencies can submit audit reports if they are granted an extension from November 15.

In addition, the Audit Bureau does not keep a record of those local educational agencies that obtained an extension from the county superintendent of schools. As a result, we cannot determine whether there were additional local educational agencies that did not submit audit reports by November 15 and had not received an approved extension.

Without audit reports, the department's Audit Bureau is unable to verify the fiscal integrity of the local educational agencies' financial transactions and verify their compliance with applicable state and federal laws and regulations. Additionally, because the Audit Bureau has not decided what action to take for local educational agencies that do not submit audit reports as required, it was at least six months late in submitting its analysis of the annual audit reports of California local educational agencies for fiscal year 1983-84 to the Joint Legislative Audit Committee.

Criteria:

California Education Code Section 41020 requires each local educational agency to file its annual audit report with the county clerk, the county superintendent of schools, the department, and the Department of Finance no later than November 15 following the end of the school district's fiscal year. The county superintendent of schools may approve an extension of this deadline to December 31 if the school district's auditor submits a written request that provides a justifiable cause for the delay.

California Education Code Section 41020.6 requires the department to submit to the Joint Legislative Audit Committee, on June 30 of each year, a report that analyzes the local educational agency audits.

Recommendation:

The department should pursue legislation that would allow the State and the county superintendents of schools to take appropriate action when school districts do not submit audit reports in compliance with current law. The Audit Bureau should also keep a record of the approved extensions to determine when a school district is delinquent. Finally, the Audit Bureau should submit its analysis of the audit reports to the Joint Legislative Audit Committee as soon as possible. In the future, the Audit Bureau should submit its analysis no later than June 30 of each year.

Item 22.

Improper Resolution of CPA Audit Report Deficiencies

Finding:

Twenty-five of the 70 local educational agencies' audit reports for fiscal year 1983-84 did not comply with federal reporting standards for the Educationally Deprived Children--Local Educational Agencies program and Improving School Programs--State Block Grants. For 14 of these 25 local educational agencies, the department's Audit Bureau did not note the deficiency in the audit report or notify the local educational agency of the weakness during the Audit Bureau's review of the districts' audit reports. If the Audit Bureau does not note deviations from the requirements and does not notify the local educational agencies of these deficiencies, the local educational agencies may continue to submit deficient audit reports. In addition, without the appropriate federal compliance report, the department is unable to verify that the local educational agencies have complied with the applicable laws and regulations.

Criteria:

The department's Audit Bureau uses the audit reports to verify the fiscal integrity of the local educational agencies' financial transactions and verify their compliance with applicable state and federal laws and regulations. California Education Code Section 41020.5 required the Department of Finance to prescribe the statements and other information to be included in the audit reports for fiscal year 1983-84. The "Standards and Procedures for Audits of California Local Educational Agencies" presents the Department of Finance's prescribed guidelines and is consistent with the federal government's standards.

Recommendation:

Chapter 268, Statutes of 1984, added California Education Code Section 14504 requiring the State Controller to review and monitor local educational agencies' audit reports prepared by independent auditors for fiscal year 1984-85. The department should inform the State Controller's office of those local educational agencies that have not complied with federal reporting standards in the past.

Item 23.

Inadequate Procedures for Ensuring That Local Educational Agencies Submit Expenditure Reports on Time

Finding:

The department's Handicapped Preschool and School Program did not receive expenditure reports from local educational agencies on time. Of 30 local

educational agencies reviewed, 20 had not submitted their fiscal year 1984-85 final expenditure reports as of the due date of September 1, 1985. Two of the 20 had still not submitted their reports at the time of our review on November 25, 1985. In addition, at the time of our review, one local educational agency had not submitted a final expenditure report for fiscal year 1983-84. If expenditure reports are not submitted on time, the department cannot determine if funds are available that could be allocated to other local educational agencies.

Criteria: Code of Federal Regulations, Title 34, Section 76.722, requires subrecipients "to furnish all reports that the State needs to carry out its responsibilities" under a federal program. To carry out its responsibilities, the department requires each local educational agency to submit expenditure reports no later than September 1.

Recommendation: The department should monitor expenditure reports for all subrecipients and set a policy to penalize those that do not submit them on time.

Item 24. **Failure To Submit Special Education Program Reports on Time**

Finding: The department did not submit the "Report of Handicapped Children and Youth Receiving Special Education" for California by the February 1 deadline. The department submitted a preliminary report on February 25, 1985, but did not submit the revised final report until September 10, 1985, more than seven months after the deadline. The federal government uses this report to allocate Handicapped Preschool and School funds to all states. Therefore, it is important for the department to submit accurate information on schedule.

Criteria: Code of Federal Regulation, Title 34, Section 300.750, requires the department to report to the Secretary of the U.S. Department of Education, no later than February 1 of each year, the number of handicapped children residing in the State who are receiving special education and related services.

Recommendation: The department should submit the "Report of Handicapped Children and Youth Receiving Special Education" for California when it is due.

Item 25.

Inadequate Monitoring of the Migrant Education Program

Finding:

During fiscal year 1984-85, the department continued to inadequately monitor the Migrant Education program. The department administers its Migrant Education program through 18 regional operating agencies. These agencies oversee approximately 375 local agencies participating in the program. In fiscal year 1984-85, as part of the department-wide effort to consolidate its monitoring of federal programs, the department conducted coordinated compliance reviews. These reviews included the monitoring of certain migrant issues at the local agency level. However, as a result of a federal audit completed in July 1982 which determined that Migrant Education recruiters did not adequately document the eligibility of children participating in the Migrant Education program, the Office of Migrant Education implemented additional procedures to review all 18 operating agencies annually. Included in the Office of Migrant Education's monitoring process, which is not included in the coordinated compliance reviews, is a review of the operating agencies' eligibility procedures and interviews with a sample of families to verify the information used to determine eligibility. It also conducts fiscal reviews of the operating agencies to ensure that they are expending funds according to their approved applications.

During our audits for fiscal years 1982-83 and 1983-84, we observed that the Office of Migrant Education did not adequately monitor local agencies to ensure that they were serving only eligible migrant children. During fiscal year 1982-83, Office of Migrant Education personnel did not conduct visits to local agencies. During fiscal year 1983-84, we observed that, although the department did conduct on-site visits, the reviewers did not adequately document findings, recommendations, and subsequent resolutions. Again, for fiscal year 1984-85, the Office of Migrant Education conducted only one visit to a local agency.

Additionally, we found that the Office of Migrant Education conducted fiscal reviews on only 5 of the 18 operating agencies during fiscal year 1984-85, even though it had planned to review all 18. During fiscal year 1983-84, we observed that the department had reviewed 3 of the 18 operating agencies. These fiscal reviews include an in-depth review of

expenditures and related documents to ensure that the operating agency is expending funds according to its approved application.

Criteria: Code of Federal Regulations, Title 34, Part 204.10(b), requires that, in order to receive a grant, the State is to submit to the Secretary of the U.S. Department of Education an annual program plan. Code of Federal Regulations, Title 34, Part 204.12(12), requires the State's annual program plan to include a monitoring and enforcement plan. To comply with this requirement, the Office of Migrant Education included in the state plan a monitoring and review section stipulating that (1) the State will monitor all operating agencies once a year, and (2) the State will conduct semi-annual reviews of each operating agency's eligibility procedures and documentation including interviews with a sample of participating families.

Recommendation: The department's Office of Migrant Education should perform eligibility and fiscal reviews of each operating agency at least once a year.

Item 26. Weaknesses in the Administration of the Migrant-Child Care Program

Finding: Weaknesses exist in the department's administration of the \$1.98 million Migrant-Child Care program, which provides services to preschool age children of migrant parents. We observed these same weaknesses in fiscal year 1983-84. The Office of Migrant Education administers all of the \$74 million Migrant Education program except for the Migrant-Child Care program, which is administered by the Child Development Division.

During their monitoring reviews of local agencies, the department's Child Development Division staff do not interview any of the parents of migrant children to ensure that recruiters from local agencies are correctly assessing eligibility. Interviewing parents is an integral part of the monitoring reviews that the Office of Migrant Education performs, as outlined in its state plan, for the regular Migrant Education program. Additionally, the department did not provide training classes on eligibility to providers for Migrant-Child Care, although it did provide these classes to the regular recruiters for the Migrant Education program.

Criteria: Code of Federal Regulations, Title 34, Part 204.3 and Part 204.12(b)(2) only makes properly identified migratory children eligible to participate in the Migrant Education program. To ensure that only eligible children participate, the Office of Migrant Education has established, in its state plan, monitoring procedures for the regular Migrant Education program that include interviewing parents of migrant children. The Office of Migrant Education has offered training classes to local agency recruiters to ensure that they recruit properly.

Recommendation: The department should ensure that the Office of Migrant Education and the Child Development Division work together to administer the Migrant Education grant consistently.

Item 27. **Inadequate Procedures for Ensuring That Local Educational Agencies Submit Expenditure Reports on Time**

Finding: The department's Vocational Education program did not receive expenditure reports from local educational agencies on time. Of 20 local educational agencies reviewed, we found that 14 (70 percent) had not submitted their fiscal year 1984-85 final expenditure reports as of the due date of October 1, 1985. Two of the 14 had not submitted their reports at the time of our review on December 17, 1985. At January 21, 1986, two final expenditure claims were still outstanding for fiscal year 1983-84. Because the expenditure reports were not submitted on time, the Vocational Education program was unable to submit by the due date the Financial Status Report for fiscal year 1984-85 or a final Financial Status Report for fiscal year 1983-84. We observed this same weakness in fiscal year 1983-84.

The Vocational Education program is also not able to calculate the local educational agencies' maintenance of effort promptly. The Financial Status Report and maintenance of effort calculation are both federal reporting and compliance requirements.

Criteria: Code of Federal Regulations, Title 34, Part 76.722, states that a state may require a subgrantee to furnish reports that a state needs to carry out its responsibilities under the program. Code of Federal Regulations, Title 34, Part 74.73(d), states that

the Financial Status Report is required annually and is due 90 days after the grant year. Final expenditure reports are due 90 days after the expiration or termination of grant support. Code of Federal Regulations, Title 34, Part 400.325, states that a local educational agency shall maintain its fiscal effort on either a per-student basis or an aggregate basis for vocational education compared with the amount expended in the previous fiscal year.

Recommendation: The Vocational Education program should change the due date for the submission of expenditure claims to a date that would allow the department to submit federal financial and compliance reports to the federal government on time. The Vocational Education program should also penalize local educational agencies that submit late expenditure reports.

Item 28. **Inappropriate Reduction of Vocational Education Allocation to a Local Educational Agency**

Finding: The Vocational Education Basic, Subpart 2, program did not allocate the proper amount of federal funds to one of the 90 local educational agencies we tested in accordance with approved federal procedures because the department uses the wrong factor in calculating the allocation amount. The error was not detected because there was no review of the allocations.

Criteria: Code of Federal Regulations, Title 34, Part 400.502(c), stipulates that a state may use the funds available under the Vocational Education Basic, Subpart 2, grant in accordance with the approved five-year state plan and annual program plan. The state plan includes the formula for the allocation of the Vocational Education funds.

Recommendation: The Vocational Education program should establish review procedures to ensure that amounts allocated to local educational agencies are accurately calculated.

Item 29. **Absence of Signatures on Vocational Education Applications**

Finding: Four of the 13 applications that we tested from local educational agencies, forwarded by the Coastal Regional Office for Vocational Education program

funding for fiscal year 1984-85, did not contain the signature of the authorized regional coordinator. We observed this same weakness in fiscal year 1983-84 for the Southern Regional Office. Without the signature of the regional coordinator, the Vocational Education program does not have assurance that the regional offices have properly reviewed and approved the applications. Also, the Vocational Education program does not have legal and binding authorization to allow the local educational agencies to expend federal funds.

Criteria: Code of Federal Regulations, Title 34, Part 400.182, requires the state plan to include procedures for local educational agencies to apply for Vocational Education grant funds. Code of Federal Regulations, Title 34, Part 400.141(f)(4), stipulates that funds will be distributed to eligible recipients on the basis of annual applications. The annual state plan requires local educational agencies to submit an application for funds to the State for approval.

Recommendation: The department should ensure that it receives applications that are approved by the regional office coordinator.

Item 30. **Inadequate Documentation of Sponsors' Eligibility for the National School Lunch and School Breakfast Programs**

Finding: The department's Office of Child Nutrition Services did not adequately document whether it had complied with all federal eligibility requirements for the National School Lunch and School Breakfast programs during fiscal year 1984-85. None of the 19 nonprofit sponsor files we reviewed had a current tax exempt letter from an authoritative board stating that the sponsor was tax exempt. The most current letter found in the 19 files was from 1980. Three of the 14 residential child care institution sponsor files we reviewed contained expired licenses. The 3 residential child care institutions had a combined total of 13 sites. Seven of the 13 sites did not have current licenses in the sponsor files. If the department's eligibility review is inadequate, ineligible sponsors may obtain program funding. The reimbursement claim payments to the three residential child care institutions without current operation licenses totaled approximately \$22,550. The federal government could suspend or terminate the program in whole or in part if it determines that the department is materially out of compliance.

Criteria: Code of Federal Regulations, Title 7, Part 210.8(e)(1), for the National School Lunch Program and Part 220.7(e)(1)(i), for the School Breakfast Program, require that nonprofit sponsors maintain their nonprofit status to be eligible for the National School Lunch and School Breakfast Programs. Code of Federal Regulations Title 7, Part 210.2(o)(2)(iii) and Part 220.2(u)(2)(iii), require that a sponsor who is a private entity and provides residential child care services must have an operation license from the proper state agency to be eligible for the National School Lunch and School Breakfast programs.

Recommendation: The department's Office of Child Nutrition Services should obtain written verification that the nonprofit sponsor is a tax-exempt entity. This requirement may be incorporated into a form already used by the Office of Child Nutrition Services in its annual sponsor renewal. Also, the Office of Child Nutrition Services should withhold payments of claims until it receives a valid license from the sponsors.

Item 31. Inadequate Follow-up Procedures on Error Messages Generated by the Claims Processing Edit Function

Finding: The department's Local Assistance Bureau (bureau) did not properly follow up on possible error messages generated by the edit function used during the processing of claims for the National School Lunch, School Breakfast, and Child Care Food programs. Possible error messages allow reimbursement claims to be processed and paid even though the reimbursement claim contains an error or irregularity. The bureau reviews only "fatal" errors generated during the claim processing edit function; it ignores "possible" errors. When the bureau does not review or follow up on the possible error messages, keypunch errors, excess meal errors, and claim completion errors may go undetected and cause an incorrect payment to the sponsor. For example, we reviewed a National School Lunch and School Breakfast programs' claim requesting reimbursement for 2,078 meals. Because of an undetected keypunch error, the bureau reimbursed the sponsor for 7,078 meals. The bureau's error listing flagged this claim with the possible error message "meals claimed in excess of enrollment"; however, the bureau did not review this message.

Criteria: Code of Federal Regulations Section 226.7(k) requires the department to revise any incomplete or incorrect Child Care Food program reimbursement claims submitted by the sponsor. The bureau uses the edit function to ensure that the reimbursement claims are complete and correct.

Code of Federal Regulations, Title 7, Part 210.11(a) and Part 220.9(a) (National School Lunch and School Breakfast programs), requires that any excess lunches that are prepared may be served to eligible children and may be claimed for reimbursement unless the state agency determines that the participant failed to plan and prepare lunches with the objective of providing one lunch per child per day. In no event shall a participant claim or be eligible for special cash assistance reimbursement for free and reduced price meals in excess of the number of children approved for free and reduced price meals.

Recommendation: The Local Assistance Bureau should calculate total excess National School Lunch and School Breakfast programs reimbursements to sponsors for fiscal years 1983-84 and 1984-85 and initiate a procedure to recover the excess payments. The bureau should follow up on all computer-generated error messages flagging reimbursement claims in which meals claimed were in excess of meals allowed and to determine if keypunch errors or claim-filing errors have occurred.

Item 32. Inadequate System Documentation of Claims Processing Edit Function

Finding: The Local Assistance Bureau did not maintain up-to-date system documentation for the claims processing edit functions of the National School Lunch, School Breakfast, and Child Care Food programs. The edit functions are designed to detect errors, irregularities, and incomplete data in the sponsors' reimbursement claims. The edit listing defines the purpose of each edit and was first printed in fiscal year 1976-77. Since that time, the bureau has not updated the listing. As a result, we found edits in the listing that were no longer valid, edits that had never become operational, one fatal error that has since been reduced to a possible error, and one fatal error not identified in the listing at all. Without adequate edit documentation, the bureau is not able to determine if the sponsors have properly prepared claims or if reimbursements are correct.

Criteria: Code of Federal Regulations Sections 210.13(a) and 220.11(a) (National School Lunch and School Breakfast programs) and Section 226.7(k) (Child Care Food Program) require that sponsors submit claims in order to receive reimbursement. The bureau's edit function should ensure that the sponsor's reimbursement claims are complete and properly prepared.

Recommendation: The Local Assistance Bureau should determine and establish requirements to maintain documentation as it relates to the edit functions.

Item 33. Inadequate Documentation for Corrections Made on Reimbursement Claims

Finding: The Local Assistance Bureau corrected National School Lunch, School Breakfast, and Child Care Food programs reimbursement claims without obtaining proper documentation from the sponsors. The bureau corrected inaccurate National School Lunch and School Breakfast programs reimbursement claims through telephone conversations with the sponsors. The bureau did not request that the sponsor submit an amended claim. Additionally, the bureau required Child Care Food Program sponsors to submit revised claims only if a claim correction involved the number of meals claimed or the number of approved sites. However, the bureau again made all other corrections based on telephone conversations with the sponsors. Without adequate documentation, there is no audit trail to follow when the bureau amends a reimbursement claim. In addition, the bureau is in an indefensible position when a discrepancy occurs between itself and the sponsor.

Criteria: Code of Federal Regulations, Title 7, Chapter II, Sections 210.13(b) and 220.11(b) (National School Lunch and School Breakfast programs) and Section 226.10(c) (Child Care Food Program), require that claims for reimbursement report information in sufficient detail to justify the reimbursement claimed. Code of Federal Regulations, Title 7, Chapter 11, Section 226.10(c), also requires each institution to certify that the claim is correct and that records are available to support the claim.

Recommendation: The Local Assistance Bureau should require National School Lunch and School Breakfast programs and Child Care Food program sponsors to submit corrected reimbursement claims.

Item 34.

Noncompliance With Audit Requirements of the Federal Child Nutrition Program

Finding:

Fifty-nine sponsors participating in the National School Lunch and School Breakfast programs have not submitted acceptable audit reports, as required by federal regulations. Each of these sponsors received more than \$25,000 during fiscal year 1983-84, and the sponsors collectively received approximately \$5,843,000 in total during that period. Further, one of the sponsors, a school district, failed to submit an audit report for fiscal years 1981-82, 1982-83, and 1983-84. This particular school district received approximately \$983,276 in federal funds under the National School Lunch and School Breakfast programs. In addition, 14 of the 70 Child Care Food Program sponsors we tested either did not submit an audit report to the department or submitted a report that did not meet the biennial audit requirement. This situation occurred because the department did not implement procedures to ensure that sponsors submit audit reports until fiscal year 1984-85.

Criteria:

Code of Federal Regulations, Title 7, Chapter II, Section 210.17(a)(4), requires that National School Lunch Program audits be conducted not less frequently than once every two years. Code of Federal Regulations, Title 7, Sections 220.15(a)(4) and 226.8(a), stipulate the same audit requirements for the School Breakfast and the Child Care Food programs.

Recommendation:

The department should enforce the new procedures to ensure that sponsors submit audit reports as required by federal regulations and that all audits are performed at least every two years.

Item 35.

Noncompliance With Federal Review Requirements for the Federal Child Nutrition Program

Finding:

The department's Office of Child Nutrition Services, Field Services Section, did not perform the required program reviews for 5 of the 70 sponsors that we tested in the National School Lunch and School Breakfast programs within the required four-year cycle. Further, the section did not perform the required program reviews of 7 of the 70 sponsors that we tested in the Child Care Food Program within the four-year cycle. Without the proper reviews, the section is unable to verify that the sponsors are complying with the appropriate federal rules and

regulations. In addition, Code of Federal Regulations, Title 7, Sections 210.19(a)(3) and 226.27(a)(1), allow the federal Food and Nutrition Services to terminate a state agency's participation, in whole or in part, when the state fails to comply with the review requirements.

Criteria:

Code of Federal Regulations, Title 7, Section 210.2(b-4), requires a state agency to perform evaluations of National School Lunch Program sponsors at least once every four years. According to a supervising child nutrition consultant, the department uses the same requirement for the School Breakfast Program. Code of Federal Regulations, Title 7, Chapter II, Section 226.6(k) (Child Care Food Program), requires the state agency to ensure that all institutions are reviewed at least once every four years.

Recommendation:

The Office of Child Nutrition Services, Field Services Section, should implement and maintain an adequate system to monitor sponsor review dates.

EMPLOYMENT DEVELOPMENT DEPARTMENT

The Employment Development Department administers 6 of the 34 federal programs we reviewed. They are the U.S. Department of Agriculture grant, Federal Catalog Number 10.551; the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.646; and the U.S. Department of Labor grants, Federal Catalog Numbers 17.207, 17.250, 17.225, and 17.246.

Item 1. Deficient Overpayment Identification System

Finding: The department's automated system for identifying claimants who received overpayments of unemployment or disability insurance benefits is deficient. During our test of overpayments of unemployment and disability insurance benefits, we found that the on-line system had no "overpayment flags" on the files for 7 of 17 claimants with outstanding benefit overpayments. Overpayment flags alert the department that the claimant has an outstanding overpayment. The department can recover the overpayment by reducing the claimant's current award by the amount of the overpayment. At June 30, 1985, the department estimated the amount of benefit overpayment receivables to be \$111 million. While the absence of overpayment flags does not prevent the department from recovering benefit overpayments, it may delay recovery. As a result, the department is denied the use of these funds for benefit payments.

We observed this same weakness during our financial audit for fiscal year 1983-84. The department responded that it reported the problem to its Data Processing Division and anticipated that the division would complete the necessary programming changes by May 1985. However, at the time of our testing of benefit overpayments, the department had not corrected the deficiencies in the program that establishes overpayment flags.

Criteria: The department's control procedures require claimants' files in the on-line system to be automatically identified when benefit overpayments are recorded in the automated system.

Recommendation: The department should correct the deficiencies in the on-line system.

Item 2.

Inadequate Bank Reconciliation Procedures

Finding:

The department does not prepare detailed listings of outstanding checks to support the amounts of outstanding checks that it reports in the monthly bank reconciliations of the Centralized Treasury System Accounts 095 and 800 (Unemployment Insurance accounts). Because the department does not maintain a detailed listing of outstanding checks, there is a lack of assurance that the amounts of outstanding checks reported on these bank reconciliations at June 30, 1985, \$326,000 and \$36 million, respectively, are correct.

We observed this same weakness during our financial audit for fiscal year 1983-84. The department responded that a new payment accounting system would be developed to provide accurate and detailed accounting for checks issued, paid, and outstanding.

Criteria:

State Administrative Manual Section 7967 requires the amount of outstanding checks reported in monthly bank reconciliations to be supported by detailed listings that show number, date, and amount of each outstanding check.

Recommendation:

The department should prepare detailed listings of outstanding checks to support the amount of outstanding checks reported in its bank reconciliations.

Item 3.

Improper Recording of Cash Transactions

Finding:

The department records the collection of unemployment and disability insurance benefit overpayments when the cash receipts are processed through the automated benefit overpayment system, OPT, rather than when the cash is received. In addition, because of normal processing delays, the department does not record some benefits paid in June until July of the following fiscal year. As a result, the department's cash balances are misstated. At June 30, 1985, the cash balance of the Unemployment Insurance Fund was overstated by \$948,000, and the cash balance of the Unemployment Compensation Disability Fund was understated by \$73,000.

Criteria: State Administrative Manual Section 10401 requires cash collections to be recorded when the cash is received for deposit. State Administrative Manual Section 8094 requires cash disbursements to be recorded daily.

Recommendation: The department should record cash receipts of benefit overpayments when the cash is received. In addition, at year end, the department should adjust cash for benefits paid in the current fiscal year but not reported until July of the following fiscal year.

Item 4. **Inadequate Accounting for Receivables and Liabilities**

Finding: The department inaccurately reported the year-end accruals for the Job Training Partnership Act subgrant agreements. Rather than basing its accruals on individual contracts, the department netted the total reported expenditures for the program against the total advances for the program. As a result, the following accounts in the Consolidated Work Program Fund were misstated at June 30, 1985: Due From Other Funds was understated by \$2 million; Due From Other Governments was understated by \$2 million; Due To Other Funds was understated by \$2 million; and Accounts Payable was understated by \$2 million.

Criteria: The department's Fiscal Management Letter No. 85-6 states that when advances to subgrantees exceed expenditures, a receivable should be recorded; when expenditures exceed advances, a payable should be recorded.

Recommendation: The department should record year-end accruals for the Job Training Partnership Act subgrant agreements on the basis of individual contracts.

Item 5. **Unreconciled Differences in Accounting for Employer Tax Receivables**

Finding: For over eight years, the department has maintained two Employer Tax Receivable subsidiary ledgers in separate computer systems, the Trial Balance system and the Employer Tax Subsidiary Ledger (ETSL) system. The department has not reconciled the two systems within a reasonable period. At June 30, 1985, the unreconciled differences amounted to \$3.9 million. Failure to reconcile the two

systems may prevent prompt detection and correction of errors and irregularities.

We observed this same weakness during our financial audit for fiscal year 1983-84. The department stated that the two systems are reconciled annually and that, given the plans to implement a single data base system, it would not be economical to divert further resources for the purpose of reconciling the two systems more frequently.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations. Reconciliations represent an important element of internal control because they provide a high level of confidence that the transactions have been adequately processed and that the financial records are complete.

Recommendation: The department plans to update the Tax Accounting system in 1986. As a result, the Trial Balance system and the ETSL system will be consolidated. Regardless of the future consolidation, the department should reconcile the data in the Trial Balance with the data in the ETSL system within a reasonable period.

Item 6. Inadequate Accounting for Tax Overpayments

Finding: The department's general ledger balances of Tax Overpayments in the following funds did not agree with the supporting subsidiary ledger maintained in the Trial Balance system: the Unemployment Fund; the Unemployment Compensation Disability Fund; the Employment and Training Tax Fund; and the Contingent Fund. The department did not reconcile the difference of \$1.6 million at June 30, 1985. Failure to reconcile the general ledger may prevent prompt detection of errors and irregularities.

We observed this same weakness during our financial audit for fiscal year 1983-84. The department responded that the Employer Tax Branch would continue its efforts to resolve the unreconciled differences until the general ledger is in balance. The department also estimated a December 1986 completion date for this reconciliation.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations.

Recommendation: The department should reconcile the general ledger balances of Tax Overpayments in the various funds to the supporting subsidiary ledger.

Item 7. **Unreconciled Subsidiary Ledgers for Benefit Overpayment Receivables**

Finding: The department maintains two Benefit Overpayment Receivable subsidiary ledgers, the manual ledger card system and the automated benefit overpayment system, OPT. The department has not reconciled the two systems for over two years. In November 1985, the department began a reconciliation of the two systems for the period ending August 31, 1984, but it does not expect to complete the reconciliation before January 1986. Failure to promptly reconcile the two systems may prevent prompt detection of errors and cause incorrect financial statement balances.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations.

Recommendation: The department should reconcile the data in the OPT system with the data in the manual ledger card system periodically and within a reasonable period.

Item 8. **Inaccurate Base Wage File**

Finding: Wage information in the Base Wage File is inaccurate. The Base Wage File is a computer file showing the amount of wages paid to each employee by an employer. The department creates the file from wage information that employers submit along with their quarterly tax returns. The department uses the wage information in the file to compute the amount of unemployment or disability insurance a claimant is entitled to receive. During our test of unemployment insurance benefit payments, we found that wage information for one of the 60 claimants that we tested did not agree with the wage information submitted by the employer. Inaccurate wage information in the Base Wage File may result in inaccurate benefit payments. The error we found in the Base Wage File resulted in an underpayment of 5 percent of the claimant's weekly unemployment insurance benefit award.

We observed a similar weakness during our financial audit for fiscal year 1983-84. It related to an inadequate audit trail for adjustments to the Base

Wage File. The department subsequently established an adequate audit trail for adjustments to the Base Wage File. The department also noted that the error rates in processing were small when compared to the large number of wage items processed each quarter.

Criteria: Government Code Section 13401(b)(1) requires state agencies to maintain effective systems of internal accounting and administrative control. Proper administration of the unemployment and disability benefit programs and correct computation of unemployment and disability insurance awards require information in the Base Wage File to accurately reflect wages paid to an employee.

Recommendation: The department should strengthen procedures to ensure that all wages are correctly posted to the Base Wage File.

Item 9. **Late Federal Financial Reports**

Finding: The department did not submit federal financial reports promptly. The department was late in submitting the Annual Status Reports for the Job Training Partnership Act (JTPA) for the period ending June 30, 1985. Additionally, the department did not promptly submit the Unemployment Insurance Financial Transaction Summary Report for any month between July 1984 and June 1985.

We observed this same weakness during our financial audit for fiscal year 1983-84. The department stated that, because of California's size, the department would have difficulty meeting the due date of ten days after the close of each month for the Unemployment Insurance Financial Transaction Summary Report, even with the ideal automated system. The department subsequently requested a waiver of the due date from the Secretary of Labor; the request was denied. The department's response did not address the Annual Status Report for the JTPA.

Criteria: U.S. Department of Labor memoranda require that Annual Status Reports for the JTPA be submitted within 45 days after the end of the reporting period. In addition, Employment Security Manual, Part V, Section 9320, requires that the Unemployment Insurance Financial Transaction Summary Report be submitted within 10 business days after the close of each month.

Recommendation: The department should file all required federal financial reports by the dates that they are due.

Item 10. **Inadequate Control of Cash Balances Held by Subrecipients**

Finding: The department has not properly controlled the cash balances of subrecipients of JTPA funds. During our review of Monthly Status of Cash reports, we found that the month-end cash balances of 5 of the 20 subrecipients that we tested had exceeded the limits established by the department. In all instances, the excess cash balances were small. The department has procedures to withhold cash advances from subrecipients with excess cash balances. However, the department has not implemented these procedures because the department determined that these procedures conflict with the Unemployment Insurance Code Section 15028. Section 15028 provides that when a subrecipient does not comply with applicable laws and regulations, the State Job Training Coordinating Council will conduct a hearing to determine whether funds shall be withheld from the subrecipient. Failure to adequately control the cash balances maintained by JTPA subrecipients could result in the U.S. Secretary of Labor's charging the department interest on the excess cash balances.

Criteria: The JTPA Program Operator Handbook requires cash balances not to exceed an average of three days' cash needs.

Recommendation: The department should establish procedures that comply with applicable codes and that adequately restrict cash advances to subrecipients who maintain excessive cash balances.

Item 11. **Subrecipients Are Not Meeting Job Training Partnership Act Expenditure Limitations**

Finding: Several of the subrecipient expenditures we tested did not meet the minimum and maximum limitations for JTPA expenditures. Subject to certain exclusions not relevant here, federal regulations require that not less than 70 percent of the JTPA funds be expended for training costs and that administration costs be limited to 15 percent of available funds. Administration costs of one of the 14 subrecipients that we tested exceeded 15 percent of the total allotment for the nine-month transition period and the first program year ending June 30, 1985. In

addition, 7 of the 10 applicable subrecipients tested did not meet the requirement that at least 70 percent of the grant be used for training.

If the subrecipients exceed the maximum limitations or do not meet the minimum limitations prescribed by federal regulations, the U.S. Secretary of Labor may require the repayment of disallowed costs.

Criteria: Subject to certain exclusions not relevant here, Code of Federal Regulations, Title 20, Section 629.39, requires that not less than 70 percent of JTPA funds be expended for training costs and that administration costs be limited to 15 percent of available funds.

Recommendation: The department should continue to monitor the subrecipient expenditure of JTPA funds and should enforce federal requirements for minimum/maximum limitations.

Item 12. Late Resolution of Job Training Partnership Act Subrecipient Audit Reports

Finding: During our review of JTPA subrecipient audit reports, we found that the department did not resolve 2 of 11 audit reports within six months of the date of issuance of the report. Additional questioned costs can result if the subrecipients do not correct deficiencies in their internal controls within a reasonable amount of time.

Criteria: Code of Federal Regulations, Title 20, Section 629.42(d), requires that subrecipient audit reports be resolved "within a timely period." The Department of Labor issued Training and Employment Information Notice No. 10-85, dated September 1985, that defined "timely" as six months from the issuance of the subrecipient report.

Recommendation: The department should resolve all subrecipient audit reports within six months of the issuance of the report.

Item 13. Inadequate Separation of Duties for Work Incentive Program Payments

Finding: During our tests of expenditures, we noted that in 2 of the 58 Work Incentive Program (WIN) transactions tested, the same employee signed the authorization for payment document and the request for payment

document. Inadequate separation of duties for the authorization and request for WIN payments can result in invalid payments.

Criteria: The WIN Handbook states that persons authorized to sign WIN allowance authorization documents (DE 8910 and DE 8911) cannot sign or initial WIN payment documents (DE 8912). This requirement is based on State Administrative Manual Section 8080.1-- Separation of Duties.

Recommendation: The central office WIN program manager should reiterate the WIN Handbook requirement to the field offices and should periodically review the applicable documents to monitor compliance with the WIN Handbook requirement.

BOARD OF EQUALIZATION

Item 1. **The Local Tax Unit Does Not Reconcile Its Control Records to the General Ledger Promptly and Accurately**

Finding: Each month, the Local Tax Unit is responsible for reconciling its control records to the general ledger. However, the unit has not developed a system of supervisory review or other internal control procedures to ensure that its reconciliations are prepared accurately and promptly. As of October 1985, the last reconciliation completed by the unit was for the month of March 1985. Also, in our testing of the February reconciliation, we identified differences amounting to \$100,000 between the control records of the Local Tax Unit and the general ledger. These differences remained unresolved in the March reconciliation. Without review procedures or other control measures, there is a lack of assurance that the control totals of the Local Tax Unit agree with the general ledger and that amounts recorded as payable to local governments at June 30, 1985, in the board's Retail Sales Tax Fund are accurately recorded.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations. Reconciliations represent an important element of internal control because they provide a high level of confidence that transactions have been adequately processed and that the financial records are complete.

Recommendation: The Local Tax Unit should establish a formal supervisory review process or other control procedures to ensure the prompt and accurate preparation of the monthly reconciliations of its control records to the general ledger.

Item 2. **Inadequate Safeguards To Prevent Duplicate Payments for Exported, Tax-Paid Gasoline**

Finding: Distributors of gasoline, who pay taxes to the State on gasoline they export for sale outside of California, are entitled either to a tax credit or a refund of taxes paid on this exported gasoline. However, the State lacks safeguards to prevent gasoline distributors from claiming both a refund

from the State Controller's office and a tax credit from the board for the same exported, tax-paid gasoline. Both the Excise Tax Unit of the board and the Tax Collection and Refund Unit of the State Controller's office are aware of this weakness, but neither has implemented procedures to prevent duplicate refunds and credits. The potential for loss is significant. For example, during the 1984-85 fiscal year, the board granted more than \$6.5 million in credits to distributors who exported tax-paid gasoline outside of California, and the State Controller's office approved more than \$8 million in tax refunds for this purpose.

Criteria: Government Code Sections 13400 to 13407 require state agencies to maintain effective internal accounting control systems. Good internal control requires that safeguards be established to prevent duplicate payments.

Recommendation: The board should obtain and compare the listings of refunds and credits made since the inception of the program on January 1, 1982, to identify payments and credits that may have been given to the same distributors for identical claims. Additionally, the board should request that the State Controller's office provide the board with a detailed monthly list of gasoline distributors to whom tax refunds are made. The board should then compare these lists to identify any duplicate payments and credits and initiate collection efforts.

Item 3.

Inappropriate Transfer of Funds

Finding: In an isolated instance, contrary to board policy, the senior accounting officer supervisor in the Fiscal Management Division transferred funds from the account for the Bay Area Rapid Transit District (BART) to the account for the Metropolitan Transportation Commission (MTC) without written authorization from the Local Tax Unit. The senior accounting officer supervisor made the transfer on the basis of a request received in a telephone conversation between an auditor in the Local Tax Unit and an accounting officer in the Fiscal Management Division. However, the State Controller's office had already made this transfer and, therefore, at fiscal year end, June 30, 1985, the BART liability accounts were understated by \$1,742,324.12 and the MTC liability accounts were overstated by the same amount. The senior accounting officer supervisor issued a letter to the

State Controller's office in October 1985 requesting a transfer of \$1,742,324.12 from MTC to BART to correct this error.

Criteria: The board's fiscal procedures manual specifies that transfer request letters to the State Controller's office be issued only when the Local Tax Unit instructs the Fiscal Management Division by letter to make such a transfer.

Recommendation: The Fiscal Management Division should issue transfer request letters to the State Controller's office only upon receipt of a letter from the Local Tax Unit authorizing such transfers.

Item 4. **Inadequate Procedures for Estimating the Receivable Accrual for the Board's Retail Sales Tax Fund**

Finding: The board's receivable estimate for the Retail Sales Tax Fund for June 30, 1985, does not agree with the amount shown in the board's financial statements. The Research and Statistics Division of the board is responsible for estimating the amount of receivables the board expects to collect during the upcoming year. The board reports this amount as accrued receivables in its financial statements. During our review of the estimated receivable, we noted that the methodology provided by the Research and Statistics Division was poorly documented. Furthermore, the estimate we obtained using this methodology did not agree with the amount shown in the board's financial statements at June 30, 1985. The original estimate of \$113 million had been arbitrarily reduced to \$110 million by the Research and Statistics Division without record of the reason for the reduction. With no formal procedures to document the receivable estimate, assurance that the estimate is appropriate is reduced.

Criteria: Government Code Sections 13400 to 13407 require state agencies to maintain effective internal accounting control systems. Good internal control requires an organization to provide adequate support for its financial statement balances.

Recommendation: The Research and Statistics Division should develop a formal methodology for estimating the board's receivable accrual and should document any changes to the estimate.

Item 5.

Inadequate Clearance Procedures for Separating Employees

Finding:

The board lacks adequate controls for clearing outstanding salary and travel advances and for recovering state-owned equipment before an employee terminates employment with the board. At June 30, 1985, these employees owed the board \$3,149 in salary and travel advances because the accounting section did not receive their clearance forms before the employees were issued final pay warrants.

Criteria:

State Administrative Manual Section 8580.4 requires agencies to ensure that terminating employees pay any outstanding salary or travel advances and that they return state-owned property before final pay warrants are released to them.

Recommendation:

The board should withhold final pay warrants from terminating employees until they clear all outstanding travel and salary advances and return all state-owned property.

DEPARTMENT OF GENERAL SERVICES

Item 1. Failure To Promptly Bill State Agencies for Printing Charges

Finding: At June 30, 1985, the Office of State Printing had not billed at least \$1.7 million in charges for printing jobs completed and shipped between October 1984 and June 1985. The production department of the Office of State Printing does not provide to the Office of State Printing's accounting office a listing of completed and shipped jobs. The accounting office bills state agencies when the production department sends the completed job file to the accounting office. However, without a listing of all completed and shipped jobs, the accounting office cannot ensure that all jobs are billed promptly. Failure to bill may impair the Office of State Printing's ability to collect the amount it is owed. In addition, until collected, these amounts are not available to pay the Office of State Printing's current obligations.

Criteria: State Administrative Manual Section 8776.3 requires that bills be prepared and sent as soon as possible after the recognition of a claim.

Recommendation: The production department of the Office of State Printing should provide to the accounting office a listing of all jobs completed and shipped to ensure prompt billing.

Item 2. Monies Not Remitted Promptly to the Legislature

Finding: The Office of State Printing did not promptly remit to the Legislature monies from the sale of legislative bills and publications. At June 30, 1985, the state printer had not remitted the receipts for April, May, and June; these receipts totaled \$944,000. According to the Office of State Printing's accounting officer, the employee responsible for remitting these monies to the Legislature left the Office of State Printing in April, and the accounting officer did not reassign this task. By not transferring these monies, the department has denied the Legislature the use of these funds to pay current obligations.

Criteria: Senate Concurrent Resolution, Chapter 9, Rule 13, requires the State Printer to remit to the Legislature on the first day of each month monies from the sale of legislative bills and publications.

Recommendation: The department should establish procedures to ensure that monies from the sale of legislative bills and publications are promptly remitted to the Legislature on the first day of each month.

Item 3. **Failure To Promptly Update the Stock Inventory System**

Finding: The Office of State Printing does not promptly update the Stock Inventory System (system). The system is a computerized record of stock on hand and includes the quantity and cost of the stock. When stock is received, the Office of State Printing records the stock in the system at the purchase order price. The Office of State Printing must adjust this price if the amount that it pays for the stock is different from the price on the purchase order. For example, if the Office of State Printing takes advantage of a vendor discount, the discounted price should be recorded in the system. The price recorded in the system is the amount that the Office of State Printing charges other state agencies for the stock used to produce the agency's printing orders. We found that the Office of State Printing was taking as long as five months to adjust the stock prices recorded in the system. Failure to promptly update the system results in inequitable charges to agencies for printing costs.

Criteria: Government Code Section 13401(b)(1) requires state agencies to maintain an effective system of internal accounting control. Good internal control requires that an inventory system provide an accurate record of inventory items.

Recommendation: The Office of State Printing should promptly record in the system the actual price of stock to ensure that it accurately bills state agencies for the stock used in agencies' orders.

Item 4. **Inaccurate Accounting for Accounts Payable**

Finding: The balance of accounts payable at the department's Office of State Printing does not accurately reflect the amounts owed. Our analysis of payments of invoices during the months of July and August 1985

showed that the balance of accounts payable as of June 30, 1985, should be approximately \$163,000 instead of the \$1,826,567 that the Office of State Printing reported. Also, the Office of State Printing does not provide a listing that supports the total amount of material it has received but not paid for by June 30, 1985. Consequently, the Office of State Printing's liabilities may be overstated, and retained earnings may be understated, by over \$1.6 million at June 30, 1985. We observed the same weakness during our financial audit of fiscal year 1983-84. According to the department's response to our report of February 25, 1985, the Office of State Printing plans to correct this problem in fiscal year 1985-86 when it modifies the system.

Criteria: State Administrative Manual Section 7630 requires that the balance of accounts payable reflect the cost of goods or services received but not paid. In addition, State Administrative Manual Section 10584 requires state agencies to prepare a detailed list of valid obligations as of June 30.

Recommendation: The department should require the Office of State Printing to adjust the balance of accounts payable to reflect the unpaid invoices and other evidence of material received. The department should also require the Office of State Printing to prepare a list detailing the balance of accounts payable on June 30.

Item 5. The Office of the State Architect Spent More Than Authorized

Finding: During the first quarter of fiscal year 1985-86, the Office of the State Architect (State Architect) spent \$278,000 more for six projects than the Department of Finance authorized. The State Architect continued working on these projects even though it did not have sufficient funds. For two of these projects, the Department of Finance has granted the State Architect permission to bill in arrears, that is, to bill the state agency after the State Architect has paid the project costs. However, this practice requires the State Architect to use funds transferred to the Architecture Revolving Fund for other projects. In addition, the State Architect has no assurance that it will be able to recover the amounts it spends in excess of the amount authorized for a project. We reported the same weakness in March 1985 in our report entitled "The Office of the State Architect Spent

More Than Authorized for Some Construction Projects," Report P-476. In response to that report, the State Architect indicated that it had adopted a policy to stop work on projects before it spends more than the amounts authorized.

Criteria: California Government Code Section 14957 specifies that money deposited in the Architecture Revolving Fund be used for the purposes that the Legislature designated in the appropriations.

Recommendation: To avoid spending more than authorized for a project, the State Architect should obtain proper authorization from the Department of Finance when it requires additional funds to complete a project.

Item 6. **Delays in Returning Unencumbered Balances in the Architecture Revolving Fund**

Finding: The department's State Architect has not promptly returned unused funds after completing projects. The State appropriates monies for construction projects from the agencies' funds that will benefit from the project. The agency receiving the appropriation then transfers the appropriated monies to the Architecture Revolving Fund. After the project is completed, the State Architect, which administers the Architecture Revolving Fund, returns the "unencumbered balances" to the agency that received the original appropriation.

The State Architect, however, takes an average of nine months to return the unencumbered balances. Of the nine months, the Department of Finance and the State Controller's office together take an average of one month to approve and return the unencumbered balance. The State Architect takes eight months to prepare the forms required by the Department of Finance and the State Controller. Several factors contribute to the delay: (1) information about the cost of a project from the computerized cost control system is not always available on time; (2) some contractors' outstanding claims are not received on time or processed promptly; and (3) some contractors' claims require arbitration. Until these funds are returned, they are not available for another appropriation. We observed this same weakness during our financial audit of fiscal year 1983-84. According to the department's response to our report of February 25, 1985, the State Architect is developing a more efficient computerized system to monitor project costs.

Criteria: California Government Code Section 14959 requires the department to transfer the unencumbered balance of the Architecture Revolving Fund to the original appropriation within three months after the State Architect completes a project.

Recommendation: The department should develop a more efficient system for monitoring the project costs so that the department can retrieve information more quickly. The department should also develop a system for tracking completed projects to accelerate the return of unencumbered funds.

Item 7. **Inadequate Control Over Disbursements**

Finding: The department does not maintain adequate control over the payment of goods or services. Specifically, the department's file of remittance advices, which provides documentation of all payments made by the department to a vendor, is not adequate to protect against paying twice for the same goods or services. The department maintains the file in alphabetical order; however, it uses only the first two letters in the vendor's name. Because of the volume of transactions that the department processes and the number of vendors, this is not an effective filing method. We tested a sample of 90 payments made by the department in fiscal year 1984-85 and found one duplicate payment. In addition, for two other payments, the department was able to locate the remittance advices only after a time-consuming search of the file.

Criteria: State Administrative Manual Section 8422.31 requires state agencies to maintain an alphabetical file of remittance advices as a central reference file to determine that payment has not been made previously.

Recommendation: The department should maintain the file of remittance advices in alphabetical order by vendor and by date of payment.

Item 8. **Inadequate Controls Over Certificates of Ownership**

Finding: The department does not have adequate procedures to ensure the prompt receipt of certificates of ownership (pink slips) from the Department of Motor Vehicles. As of November 30, 1985, the department was unable to locate the pink slips for two automobiles purchased in March and June 1985 at a

cost of \$54,815. Failure to obtain and safeguard the pink slips could result in a misappropriation of state property.

Criteria: State Administration Manual Section 4114 states that the certificate of ownership must be kept by the owning agency in a safe place to avoid loss.

Recommendation: The department should establish procedures to ensure prompt receipt of certificates of ownership from the Department of Motor Vehicles.

Item 9. **Failure To Reconcile Department's Cash Records With Bank Statement**

Finding: The department did not reconcile the cash balance in its general ledger to the cash balance on its bank statement. At June 30, 1985, the department's cash balance in the general ledger was approximately \$5,192 higher than the balance on the bank statement. Failure to reconcile accounts can result in the misstatement of cash balances and may prevent the detection of irregularities such as unauthorized disbursements or the failure to deposit money.

Criteria: State Administrative Manual Section 7921 requires agencies to reconcile the cash balance in their records to the bank statement sent by the State Controller each month.

Recommendation: The department should reconcile its June 30, 1985, cash balance to the bank statement and perform this reconciliation monthly as required.

Item 10. **Failure To Audit State Agencies With Purchase Delegations**

Finding: As of December 10, 1985, the department has not audited within a three-year period 15 of the 114 agencies that have purchase delegations. A purchase delegation allows state agencies to make individual purchases under a specified dollar amount. According to the department's Office of Procurement, only two employees are available to conduct these audits. The Office of Procurement has performed a desk review of purchases made by these 15 agencies and plans to complete audits of these agencies by March 1986. Because the department has not audited the state agencies, it lacks assurance that state agencies are making purchases in accordance with state law.

Criteria: Public Contract Code Section 10333 requires the department to audit, at least once in every three-year period, state agencies that have purchase delegations.

Recommendation: The department should schedule audits so that each agency that has been granted a purchase delegation is audited at least once in every three-year period.

Item 11. **Inadequate Separation of Payroll Duties**

Finding: Department employees who process attendance and other payroll documents also receive undistributed salary warrants. Unless these duties are separated, an employee could authorize a fictitious payment for personal use. We observed this same weakness during our financial audits for fiscal years 1982-83 and 1983-84. According to the department's response to our report of February 25, 1985, the department reassigned the duties to correct the weakness. However, the weakness still exists.

Criteria: State Administrative Manual Section 8580.1 states that persons who receive salary warrants, distribute salary warrants to employees, or handle warrants for any other purpose, should not be authorized to process or sign personnel documents.

Recommendation: The department should assign the safekeeping of undistributed salary warrants to employees other than those who certify or process payroll and personnel documents.

Item 12. **Incorrect Calculation of Lump-Sum Payments to Separating Employees**

Finding: Department payroll clerks incorrectly computed one of the five lump-sum separation payments that we tested. This incorrect payment was caused by errors in projecting over future pay periods the amount of leave that employees would earn. The error of \$106 was an underpayment to the employee.

Criteria: State Personnel Transactions Manual Section 623 describes the calculations that are needed to determine lump-sum payments to employees who are leaving state employment.

Recommendation: The department should ensure that all payroll clerks are trained in calculating lump-sum payments to separating employees. The payroll supervisor should review the accuracy of all lump-sum calculations before authorizing payments.

Item 13. **Inadequate Reporting of Leasing Information**

Finding: The department's records do not provide enough information about the State's lease obligations for the State Controller to comply with the disclosure requirements under generally accepted accounting principles (GAAP) when preparing the State's annual financial report. GAAP require that the State as lessee disclose obligations for future lease payments in a summary showing future payments for each fiscal year. However, the department's space and equipment lease records do not separate future rental payments by fiscal year. As a result, the State Controller has to expend considerable time and effort to separate the information into fiscal years. We also found that the department commingles lease records for equipment with the records of personal service and service agreements. As a result, only 12 percent of the contracts in these records relate to equipment leases. This lack of separation in the records makes it difficult for the State Controller to extract the information needed to make the disclosures. We observed this same weakness during our financial audit for fiscal year 1983-84. The department disagreed with our finding, stating that it is the responsibility of the State Controller and the Department of Finance to implement the changes to conform with GAAP.

Criteria: Governmental accounting and reporting standards require that governmental accounting systems allow the fair presentation and full disclosure of the financial position and results of financial operations in accordance with GAAP. California Government Code Section 12460 requires the State Controller to prepare the State's annual report as closely as possible in accordance with GAAP. GAAP require the disclosure of information about the lessee's rental activities to include a summary of the minimum rental payments that the lessee will make in each future year.

Recommendation: At the end of each fiscal year, the department should prepare a summary of the State's future lease payments by fiscal year. The department should also keep its file of equipment leases separate from its file of personal services and service agreements.

Item 14.

The Audit Section Is Not in Compliance With Internal Auditing Standards

Finding:

The department's internal audit section is not in compliance with the independence standard that the Institute of Internal Auditors, Inc., has established. Under the current organizational structure, the chief of the Office of Management, Technology, and Planning has authority over the audit section. He also has authority over some activities in other sections that the audit section may have to review. For example, the internal auditors in the audit section may review the data processing services section, which is a unit within the Office of Management, Technology, and Planning. Since the manager of the audit section and the manager of the data processing services section both report to the chief of the Office of Management, Technology, and Planning, it would be possible to withhold audit findings about the data processing services section from top management. We observed the same weakness during our financial audit for fiscal year 1983-84. The department disagreed with our finding, stating that the organizational structure does not impede the accomplishment of audit responsibilities as required by existing standards.

Criteria:

California Government Code Section 1236 requires state agencies that conduct internal auditing activities to use the "Standards for the Professional Practice of Internal Auditing," of the Institute of Internal Auditors, Inc. The independence standard states that "the director of the internal auditing department should be responsible to an individual with sufficient authority to promote independence and to ensure broad coverage, adequate consideration of audit reports, and appropriate action on audit recommendations."

Recommendation:

The department should comply with the independence standard for internal auditors by having the manager of the audit section report directly to a deputy director.

DEPARTMENT OF HEALTH SERVICES

The Department of Health Services administers 2 of the 34 federal programs we reviewed. They are the U.S. Department of Agriculture grant, Federal Catalog Number 10557, and the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.714.

Item 1. Failure To Post Payments to Control Logs

Finding: The department did not always post payments it made on contracts or master agreements to control logs. We found two contract payments that were not posted to control logs until we notified claims personnel of the problem. In one of these cases, the payment had been made more than four months before it was posted on the control log. Further, we found a payment on an intra-agency agreement for which the control log was missing. The failure to post payments to control logs increases the risk of duplicate payment of invoices or overpayment on contracts.

Criteria: State Administrative Manual Section 8422.31 requires that payments be recorded on the documents authorizing the expenditures or on a memorandum record of payments, such as a control log.

Recommendation: The department's claims personnel should post payments to appropriate control logs when payments are made.

Item 2. Failure To Correctly Identify Obligations

Finding: The department's accounting personnel did not accurately identify which contract amounts for the cleanup of hazardous substances constituted actual obligations on June 30, 1985. As a result, the department overstated the obligations it reported to the State Controller by \$9.7 million. The State Controller needs an accurate differentiation to present financial statements in accordance with generally accepted accounting principles.

Criteria: A State Controller's memorandum issued on May 24, 1985, requires that agencies analyze unliquidated encumbrances to determine what portion is for encumbrances outstanding (goods or services not received as of June 30) and what portion is for obligations (goods or services received as of June 30). According to generally accepted

accounting principles, a liability is not established until the goods or services are received.

Recommendation: The department's accounting personnel should accurately determine which of its unliquidated encumbrances are obligations at June 30, 1985.

Item 3. **Failure To Liquidate Encumbrances**

Finding: The department's Claims Unit does not always liquidate encumbrances as claims are paid. We found over \$1.5 million in amounts paid that had not been liquidated from the Encumbrances account by the Claims Unit. Not liquidating encumbrances causes the fund's balance that is reserved, and therefore unavailable for other use, to be overstated.

Criteria: State Administrative Manual Sections 8340 and 10504 require that the Reserve for Encumbrances and Encumbrances account balances be reduced when claims are filed for payment by the State Controller.

Recommendation: The department Claims Unit should ensure that encumbrances are liquidated as claims are filed for payment.

Item 4. **Failure To Comply With Federal Financial Management Requirements for Toxic Cleanup Contracts**

Finding: The department's Toxic Substances Control Division (division) procured certain of its toxic cleanup contract services through noncompetitive negotiation without appropriate approval. Of the ten audited contracts funded by federal cooperative agreements and totaling \$26.7 million, we found that two contracts totaling \$3.2 million were awarded on a noncompetitive basis without the approval of the U.S. Environmental Protection Agency (EPA). Additionally, the division paid invoices submitted by one of the contractors despite the lack of supporting documentation such as travel itineraries, airline tickets, car rental receipts, automobile mileage, and other miscellaneous receipts. Of the audited total of \$22,980 paid to the contractor for travel and miscellaneous costs for fiscal year 1984-85, \$13,486 was not supported. Failure to comply with federal requirements may result in decertification of the department's contracting and payment systems, and, consequently, contract costs incurred by the State may not be eligible for reimbursement from the federal government.

Criteria: 40 Code of Federal Regulations, Section 33.605, states that recipients may use noncompetitive negotiation to award contract services provided that the EPA authorizes the noncompetitive negotiation. Further, Section 30.510(b) requires that records and support documents show the application of funds.

Recommendation: The department should comply with federal financial management requirements in contracting and accounting for toxic site cleanup services.

Item 5. **Failure To Perform a Prepayment Review of Invoices From Certain Medical Assistance Program Providers**

Finding: The department's Medical Assistance Program (MAP) requires certain patients to pay a share of the cost of care they receive from long-term care providers. For those providers who issue more than one invoice per month (split billings), the department requires that the patient's share of costs be deducted from the first billing of the month before the MAP portion is paid. Subsequent billings from the provider may report that the patient's share of costs has been deducted from the first billing; however, the department does not require its fiscal intermediary, the Computer Sciences Corporation, to verify that the share of costs has been deducted. Therefore, split billings could be processed without the patient's share of costs having been deducted, and, consequently, the State may be paying for an unauthorized share of costs. For 1984-85, long-term care billings were \$749 million, but we did not determine what portion involved split billings.

Criteria: 42 Code of Federal Regulations, Section 447.45, and good internal controls require that the department make a prepayment review of medical assistance claims. Verifying the patient's payment of share of costs for split billings is one procedure in such a review.

Recommendation: For split billings, we recommend that the department analyze the costs and benefits associated with requiring verification that the share of costs is paid from the first monthly billing. The department should require this verification if it is economically practical.

DEPARTMENT OF HOUSING AND COMMUNITY DEVELOPMENT

The Department of Housing and Community Development administers one of the 34 federal programs we reviewed. It is the Department of Housing and Urban Development grant, Federal Catalog Number 14.228.

Item 1. **Inadequate Monitoring of Cash Advances**

Finding: The department does not properly monitor cash advances to grantees. Nine of 11 grantees we reviewed showed excessive cash balances. In two instances, grantees maintained excessive average cash balances of approximately \$300,000 for over four months. The State did not lose money as a result of the excessive balances because the federal government immediately reimburses the State for the advances; however, the federal government lost interest earnings that it could have received on funds that the State requested too soon. For this reason, the federal government may impose sanctions on the department.

Criteria: United States Department of Treasury Circular 1075 requires that cash advances be limited to the minimum amounts and the actual cash requirements needed for carrying out the purpose of the program. Circular 1075 also stipulates that the timing and amount of cash advances be as close as administratively feasible to the actual disbursements of the recipient organization.

Recommendation: The department should establish specific guidelines for the size of the cash balance a grantee may maintain before being required to return the funds to the State. The department should then use the guidelines to monitor cash advances and request the return of funds, if necessary.

DEPARTMENT OF MENTAL HEALTH

The Department of Mental Health administers one of the 34 federal programs we reviewed. It is the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.992.

Item 1. Audits of Counties Do Not Comply With Federal Block Grant Audit Requirements

Finding: The department failed to comply with audit requirements of the U.S. Public Health and Welfare Code related to audits of counties. The audit reports prepared by the department's audit section did not include: (1) a statement that the examination was made in accordance with generally accepted governmental auditing standards; (2) statements of program costs and notes to statements; (3) a statement on the study and evaluation of internal accounting controls as part of the financial and compliance audits; and (4) a statement of positive assurance on those block grant items tested for compliance and a statement of negative assurance on those items not tested, together with comments on material instances of noncompliance. These deficiencies occurred because the department's audit section was not aware of the specific block grant audit requirements. Failure to assure compliance with federal requirements may jeopardize the State's continued receipt of federal block grants.

Criteria: United States Code Title 42, Section 300X-5, requires that the audits of counties of block grants meet the standards established by the Comptroller General for the audit of governmental organizations, programs, activities, and functions. These standards specify that audit reports are to include all of the items listed in the finding above.

Recommendation: The department should direct its audit section to comply with federal requirements for audits of counties.

Item 2. Delay In Audits of Counties

Finding: The department has not complied with state requirements to audit block grant funds within six months after the close of the fiscal year. As of May 31, 1985, the department had not completed 8 out of 26 audits of counties required to be completed

for fiscal year 1982-83 block grant funds. Therefore, there were 8 audits that were still in progress as of May 31, 1985, 23 months after the end of the 1982-83 fiscal year. The department has not completed any of the audits of fiscal year 1983-84 block grants. According to the manager of the department's audits section, the audits were late because the counties were late in submitting their fund cost reports. Because the department has not audited the counties on time, it lacks assurance that disbursements of \$22 million were used for authorized purposes.

Criteria: California Government Code Section 53134(c) requires the department to complete the audits of block grant funds within six months after the close of the fiscal year.

Recommendation: The department should complete the audits of block grant funds allocated to counties within six months after the close of the fiscal year.

Item 3. Failure To Develop Procedures to Resolve Audit Findings

Finding: The department has not developed procedures to determine the corrective action taken or planned by counties that receive block grants, nor has it developed procedures to resolve differences. Because the department does not have such procedures, it lacks assurance that the counties will take corrective action related to \$819,000 of unresolved costs determined to be questionable by the department's auditor. The department also lacks assurance that counties will correct other internal control deficiencies reported in the department's audits of fiscal year 1982-83 county federal block grant funds.

Criteria: U.S. Office of Management and Budget Circular A-102, Attachment G, requires the department to develop procedures that will ensure prompt and appropriate resolution of audit findings and recommendations concerning counties' administration of block grant funds.

Recommendation: The department should develop procedures to resolve differences and to ensure that counties take appropriate and prompt corrective action to resolve audit issues.

Item 4.

Failure To Monitor Counties' Cash Balances

Finding:

The department does not monitor federal cash balances of counties as required by federal and state regulations. For instance, the department does not require counties to submit quarterly Grant Cash Transactions Reports. These reports provide the information the department needs to determine (1) if the State is advancing federal cash to counties before it is needed, resulting in loss of interest earnings to the State or federal government; or (2) if counties are using nonfederal money to initially finance the federal block grant program, resulting in loss of interest earnings to counties.

Criteria:

U.S. Office of Management and Budget Circular A-102, Attachment G, requires the department to develop procedures to monitor cash advances to counties. State Administrative Manual Section 8760 specifies that departments administering block grants will require counties to submit Grant Cash Transactions Report quarterly.

Recommendation:

The department should develop procedures to evaluate and monitor federal cash balances of counties by requiring counties to submit Grant Cash Transactions Reports quarterly.

Item 5.

Inadequate Control Over Cash Advances to Counties

Finding:

The department does not provide adequate internal control over cash advances to counties for Alcohol, Drug, and Mental Health Services block grants. At present, the department does not review counties' requests for cash advances to determine if the counties meet all federal and state requirements before making cash advances. As of October 31, 1985, Los Angeles County and Sacramento County had not submitted either their final cost reports for fiscal year 1983-84 or their quarterly Grant Financial Status Reports for the quarter ending June 30, 1985. However, these counties received cash advances of \$5,347,000, and \$25,725, respectively, from December 1, 1984 through June 30, 1985. The department's policy requires suspension of cash advances to counties if they fail to submit final cost reports by November 30. Failure to assure compliance with federal requirements may jeopardize the State's continued receipt of federal block grants.

Criteria: U.S. Office of Management and Budget Circular A-102, Attachment G, requires the department to develop procedures to provide proper control over cash advances to counties. Also, State Administrative Manual Section 8760, requires the department to take appropriate action if counties do not submit timely grant reports.

Recommendation: The department should develop, review, and approve procedures and take action that will ensure compliance with state and federal requirements.

DEPARTMENT OF MOTOR VEHICLES

Item 1.

Late Deposit of Receipts in Banks

Finding:

The department's headquarters and field office cashiering units are frequently late depositing cash and checks in banks. The department collects approximately \$2.5 billion annually. Approximately 64 percent of all deposits made by the headquarters Enhanced Renewal/Calvo unit and approximately 24 percent of the deposits of all other units within headquarters and field offices are made later than the next working day following receipt.

At a 10 percent interest rate, which approximates the interest earned by the State Pooled Investment Account in fiscal year 1984-85, the State lost at least \$536,000 in interest income during fiscal year 1984-85 because of late deposits by the department. Of this amount, \$257,000 was due to late deposits made by the headquarters Enhanced Renewal/Calvo unit. The remaining \$279,000 was due to late deposits made by all other units within headquarters and field offices.

The volume of cash receipts received at the headquarters Enhanced Renewal/Calvo unit on Mondays usually far exceeds the volume that can be processed in one day. Therefore, the unit must carry over receipts to following workdays for processing before deposit.

The late deposits in the field offices appear to result from the department's concern about holding cash on the premises overnight. Most of the coin and currency collections are given to an armored car service late in the afternoon so that the field offices will not have to hold coin and currency overnight. Checks are frequently prepared for deposit and given to the armored car service late in the afternoon on the workday following receipt. The deposits, consisting of coin and currency from the current day and checks from the previous day, are then held overnight by the armored car service and deposited with the bank the next day.

The department's accounting personnel do not investigate unusual delays between the dates that the department prepares receipts for deposit and the dates placed on the deposit slips by the banks.

Criteria: State Administrative Manual Sections 8030.1 and 8030.2 require bank deposits to be made on the day of receipt if possible and no later than the next working day.

Recommendation: The chief of the headquarters processing division should consider having the department pick up mail at the Sacramento post office on Saturdays and process receipts on Saturdays or Sundays to prepare Saturday's mail for bank deposit on Monday. This should help to reduce the volume of mail received on Mondays for processing and thus expedite the deposits to the bank.

Additionally, the chief of the field operations division should require that cash and currency collected on each workday continue to be picked up by the armored car service late in the afternoon to keep from holding the cash on the premises overnight; however, he should require that checks payable to the department and restrictively endorsed be prepared for deposit at the close of each workday or the morning of the following workday and be delivered to the bank by a department employee or courier service before 1:00 p.m. so that the deposit will be credited on the day of delivery.

Finally, the department's accounting personnel should compare bank deposit dates with the date the department prepared the receipts to ensure that the department's headquarters and field office cashiering units are depositing receipts promptly.

Item 2.

Inadequate Support for Uncleared Collections

Finding: The department is unable to provide a detailed list of uncleared collections that supports the account balance. The June 30, 1985, uncleared collections account balance totaled approximately \$187 million. The money that is in the uncleared collections account is unavailable for state expenditure or disbursement to the local governments.

The department's uncleared collection account contains millions of receipts, including suspense receipts which are valid for four years. The cost of providing a detailed listing of these receipts under the current accounting system is prohibitive. Therefore, the department has not prepared one, and we could not verify the uncleared collections account balance by testing the transactions that support the total.

We observed the same weakness during our financial audits for fiscal years 1982-83 and 1983-84. To provide a detailed listing of uncleared collections, the department has established an automated uncleared collections file for 100 of the 156 field offices. The remaining 56 field offices prepare listings manually. The department anticipates fully implementing the automated uncleared collections file by 1992. Additionally, following completion of our field work, the department formulated plans to transfer to revenue approximately \$87 million of the June 30, 1985, uncleared collections account balance representing incomplete transactions between one and four years old, to make this money available for state expenditure or disbursement to local governments. The department estimates that only a small percentage of the uncleared collections will be refunded. The department will adjust current revenue as refunds are made. Further, the department is proposing legislation to change its obligation for fees received for incomplete transactions from four years to one year.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations. Reconciliation of subsidiary records with associated control accounts represents an important element of internal control because it provides a high level of confidence that transactions have been adequately processed and that the financial records are complete. Also, receipts should be analyzed and classified as soon as possible to be made available for their intended purposes.

Recommendation: The department should consider expediting the automation of its field offices and continue its plan to clear receipts between one and four years old and to prepare legislation to reduce the valid life of suspense receipts to one year.

Item 3. Inadequate Electronic Data Processing Backup Procedures

Finding: The department does not have provisions for off-site backup hardware for its electronic data processing (EDP) system in the event of a major disaster. The chief of the data processing division said that there are currently no facilities in California that have adequate hardware that is compatible with the department's configuration and that is also capable of processing the department's volume of work. In addition, he said that the Department of Finance is

currently studying this problem. A major shutdown of the department's EDP system could result in the loss of revenues to the State and local governments and the loss of information data bases used by law enforcement agencies.

Criteria: State Administrative Manual Section 4909.8 requires departments having critical EDP systems involving collection of income to insure that backup procedures are in place.

Recommendation: The department should continue to work with the Department of Finance to establish backup procedures for its EDP system.

Item 4. Electronic Data Processing System Access Controls Are Not Adequate

Finding: The department has not adequately restricted access to its EDP system. Attempts to use the on-line terminals with the wrong password result in error messages that are delivered only to the password input terminal. Further, the system does not "lock out" a user after a given number of unsuccessful attempts to gain access from an on-line terminal, nor does the department's Phase II Automation Project record all unsuccessful attempts to access the system from an unauthorized terminal or with an unauthorized password. Inadequate control over access could result in unauthorized changes to master data files.

The manager of the Phase II Automation Project said that the department has not implemented such a control feature in its EDP system because the users of the department's Phase II Automation Project have not viewed these access controls as high priority items. Therefore, the users have not requested these specific control features.

Criteria: State Administrative Manual Section 4846.5 requires management to limit the access to master data files to properly authorized individuals to protect the integrity of the data generated by the EDP systems.

Recommendation: The department should implement a system that will "lock out" an on-line terminal after a given number of unsuccessful attempts to gain access and record all unsuccessful attempts to access its on-line terminals from an unauthorized terminal or with an unauthorized password. The record of unsuccessful attempts should be reviewed on a regular basis by a control group.

Item 5.

Lack of Control and Accountability Over Revolving Fund

Finding:

The department's revolving fund account contained two unsupported amounts as of June 30, 1985. One amount was an unexplained difference of \$1,463. The other amount of \$27,084 was reportedly spent for postage. However, during our review and as of December 20, 1985, the date of our exit conference, the department could not locate the postage invoices relating to the expenditures and therefore could not obtain reimbursement from the State Controller's office.

Failure to adequately maintain control and accountability over the revolving fund activities can result in the misstatement of cash balances and prevent the early detection of irregularities such as unauthorized or excessive disbursements.

Criteria:

State Administrative Manual Section 7951 requires all state agencies to retain sufficient detail in their offices to support general ledger account balances.

Recommendation:

The department's accounting office should consistently review all revolving fund expenditures to ensure that revolving fund reimbursement claims have been filed properly and promptly and the total fund is accounted for.

Item 6.

Improper Preparation of Financial Statements

Finding:

The department does not prepare its year-end financial statements in accordance with the State Administrative Manual. We found the following deficiencies:

- The department did not correctly prepare Report 2, "Accrual Worksheet." The department failed to include approximately \$152 million of amounts related to liabilities on Report 2 for the Motor Vehicle Account - State Transportation Fund.
- The department's Report 6, "Final Budget Report," for the Motor Vehicle Account - State Transportation Fund does not reconcile to Report 5, "Final Reconciliation of Controller's Accounts With Final Budget Report," or to the department's allotment expenditure ledger. The Final Budget Report shows \$11,079 more in

expenditures and \$2,998,531 more in unencumbered balances than the Final Reconciliation of Controller's Accounts With Final Budget Report.

- Several account balances shown on Report 7, "Pre-Closing Trial Balance," did not agree with amounts shown in the department's general ledger for the Motor Vehicle Account - State Transportation Fund. For example, the amount shown in the Pre-Closing Trial Balance for Prior Year Appropriation Adjustments is \$33,375 less than the amount shown in the general ledger. Additionally, Appropriation Expenditures on the Pre-Closing Trial Balance was \$14,909 less than the amount shown in the general ledger.

The department's accounting personnel did not properly review and reconcile the various required reports to each other and with supporting agency records. Because of these deficiencies, the department's financial statements are neither complete nor accurate.

Criteria:

Good internal control requires an agency to have procedures to fairly present its financial statements and to find its own errors. The department's financial statements should be prepared in accordance with the instructions provided in the State Administrative Manual (SAM). SAM Section 7953 states that the total of each vertical column of Report 2 must agree with a specific account balance shown on the June 30 Final Trial balance. Additionally, SAM Sections 7957 and 7961 require Report 5 to agree with Report 6. The final reconciliation as of June 30 is based on the final budget report. Finally, Report 7 should be prepared from the department's June 30 general ledger account balances. This is consistent with SAM Section 7230, which identifies accounting records as the source for financial reports.

Recommendation:

The fiscal officer should ensure that the accounting personnel have properly reviewed and reconciled the various required reports with each other and with supporting agency records. All required year-end financial statements should be prepared in accordance with the State Administrative Manual.

Item 7.

Failure To Retain Records

Finding:

The department does not maintain certain records that are necessary to verify the propriety of revenue allocations to local governments. These records include a detailed listing that supports the department's "Statement of Trailer Coach Transactions and Vehicle License Fee Collected Report." In fiscal year 1984-85, the State Controller's office disbursed \$10,461,617 in trailer coach revenues to local governments. However, without this detailed listing, we could not verify the accuracy of the amounts allocated to the local governments.

Criteria:

State Administrative Manual Section 1667 requires that agencies consider established criteria including administrative, legal, fiscal, and auditing requirements in determining record retention periods. State Administrative Manual Section 1671 recommends that agencies retain most fiscal records at least two years or until after audit.

Recommendation:

The department should retain records that support the propriety of all financial accounting transactions at least two years or until after audit to meet the needs of the internal and external auditors and to provide for its own protection.

DEPARTMENT OF REHABILITATION

The Department of Rehabilitation administers one of the 34 federal programs we reviewed. It is the U.S. Department of Education grant, Federal Catalog Number 84.126.

Item 1. The Internal Audit Section Does Not Comply With Internal Auditing Standards

Finding: The department's internal audit section does not comply with the independence standard that the Institute of Internal Auditors, Inc., has established. Under the present organization of the department, the deputy director for administrative services has authority over the audit section. He also has authority over other sections that the audit section may have to review, such as accounting, budgeting, and personnel. It is difficult for an auditor to remain objective when auditing activities directly supervised by the auditor's immediate supervisor.

Criteria: The "Standards for the Professional Practice of Internal Auditing," of the Institute of Internal Auditors, Inc., state that the internal audit section should be responsible to an individual with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.

Recommendation: The department should comply with the independence standard for internal auditors by having the director of the audit section report directly to the chief deputy director.

Item 2. The Department's Reports to the Federal Government Need To Be Improved

Finding: The department's procedures to prepare the federal Financial Status Report (FSR-269) are inadequate. The department's financial management system does not provide to the accounting section all the information it needs to prepare the FSR-269. For example, the financial management system method of distributing administration expenditures to various programs is different from the method used to charge administration costs to the federal government. Consequently, the accounting section spends additional time to develop the administration costs

chargeable to the federal government. In addition, the department does not reconcile expenditures reported in the financial management system with the expenditures charged to federal programs. Therefore, there is no assurance that the amounts reported in the FSR-269 are adequately supported by amounts in the accounting records.

Criteria: The Office of Management and Budget Circular A-102, Attachment G, requires that the financial management system contain information that is supported by accounting records from which the basic financial statements have been prepared. Also, good accounting practice requires reconciliation of amounts in the federal financial reports with the amounts in the accounting records.

Recommendation: The department should change the financial management system method of distributing administrative costs to different programs to include the method established to charge administrative costs to the federal government. In addition, the accounting unit should reconcile the amounts reported in FSR-269 with the amounts reflected in the accounting records.

Item 3

Delays In Requesting Federal Funds

Finding: During the first nine months of fiscal year 1984-85, the department requested federal monies after claims were paid by the State Controller. As a result, the State lost approximately \$311,000 in interest earnings in the three quarters, based on an assumed interest rate of 10.7 percent. We reported the same weakness in fiscal year 1983-84, when the State lost approximately \$120,000 in interest earnings. In the report, we recommended that the department develop procedures to estimate its cash needs and request federal funds in time for the State to receive federal monies before it disburses the monies for the federal program. Effective April 1, 1985, the department implemented new procedures in drawing federal funds. Based on our observation of the process, we believe that this new procedure will improve the department's cash management.

Criteria: State Administrative Manual Section 8099 requires state agencies making expenditures from a state fund to ensure that federal monies are received by the time the expenditures are made.

Recommendation: The department should continue using its new procedure of drawing federal funds to ensure that federal monies are received by the time the expenditures are made.

Item 4 **The Department Has Not Submitted a Three-Year State Plan for Providing Vocational Rehabilitation Services**

Finding: The department did not submit a state plan for vocational rehabilitation services for the three-year period beginning in fiscal year 1985-86 by July 1, 1985. The State was not able to file the plan forms until the Office of Management and Budget provided the changed forms and necessary instructions. However, failure of the department to submit a state plan on time may jeopardize the State's eligibility for federal grants.

Criteria: Code of Federal Regulations 34, Part 361, Section 361.3, requires the State to submit a state plan for approval for each three-year period no later than July 1 of the year preceding the first fiscal year for which the state plan for vocational rehabilitation services is submitted.

Recommendation: The department should comply with the federal regulations by submitting a state plan for vocational rehabilitation services by July 1.

DEPARTMENT OF SOCIAL SERVICES

The Department of Social Services administers 8 of the 34 federal programs we reviewed. They are the U.S. Department of Agriculture grant, Federal Catalog Number 10.551 and the U.S. Department of Health and Human Services grant, Federal Catalog Numbers 13.667, 13.645, 13.646, 13.679, 13.802, 13.808, and 13.814.

Item 1. Late Financial Statements

Finding: The department submitted estimated financial statements to the State Controller's office on October 1, 1985. It did not submit its final financial statements to the State Controller's office until January 23, 1986, more than five months after they were due. The Chief of the Accounting and Systems Bureau attributes the department's inability to meet the financial statement deadlines primarily to delays and inaccuracies associated with the routine processing of reports using the California Statewide Accounting and Reporting System (CALSTARS). Failure to submit final financial statements when they are due delays the State Controller's office's compilation of financial statements for the State of California.

Criteria: State Controller's memorandum dated May 24, 1985, requires multi-funded agencies to submit their General Fund financial statements by July 31. Financial statements for funds other than the General Fund must be submitted by August 20.

Recommendation: The department should implement procedures to ensure that it submits its year-end financial statements on time.

Item 2. Misstatement of Expenditures and Liabilities

Finding: The department overstated its Federal Trust Fund and General Fund expenditures and liabilities at June 30, 1985, by an estimated \$288 million and \$36 million, respectively. In most instances, the department's accounting unit inappropriately accrued all of its remaining appropriation balances without determining whether there was supporting documentation to substantiate these year-end accruals. Because the accounting unit did not determine whether these accruals were valid state obligations, the department's year-end accruals and thus its financial statements were misstated.

Criteria: State Administrative Manual Section 10584 requires agencies to make accruals of expenditures at the end of the fiscal year. Good internal control requires an agency to ensure that these accruals are accurate.

Recommendation: The department should establish procedures to ensure that amounts accrued are as accurate as can be determined and that all appropriate amounts are properly supported.

Item 3. **Improper Identification of Encumbrances**

Finding: On its General Fund Report of Accruals, the department inappropriately reported \$1.2 million of accounts payable as encumbrances because the department did not analyze accounts payable to determine whether goods were received or services were provided before or after June 30. If the department does not properly identify encumbrances in its financial statements, the State Controller's office does not have sufficient information to prepare the State of California's financial statements in accordance with generally accepted accounting principles.

Criteria: State Controller's memorandum dated May 24, 1985, to state agency accounting officers instructed agencies to report the amount of encumbrances applicable to their accruals in such a way that financial statements could be prepared in accordance with generally accepted accounting principles. Under generally accepted accounting principles, encumbrances are that portion of the accruals that represent goods received or services provided after June 30.

Recommendation: During year-end closing, the department should analyze its accruals to determine whether goods were received or services provided before or after June 30 and report them appropriately as liabilities or encumbrances.

Item 4. **Inadequate Control Over Local Assistance Appropriation in the General Fund**

Finding: Preliminary closing reports indicated that the department overspent the General Fund Program 20 (In-Home Supportive Services) item for fiscal year

1984-85 by approximately \$129 million. We determined that these reports were inaccurate because the department failed to record Plans of Financial Adjustment notices that transferred federal funds to the General Fund Program 20. In addition, the department failed to implement CALSTARS on-line edits to monitor expenditures. Although the department did not overspend this program, the department could not effectively monitor its General Fund Program 20 expenditures during fiscal year 1984-85.

Criteria: Government Code Section 13401 requires that each state agency maintain effective systems of internal control as an integral part of its management practice. Government Code Section 13403 states that a system of procedures that provides effective accounting control over expenditures is one of the elements of a satisfactory system of internal control.

Recommendation: The department should implement CALSTARS on-line edits to monitor expenditures.

Item 5. **Appropriation Balances in the State Controller's Office Are Not Reconciled Promptly to CALSTARS**

Finding: Throughout fiscal year 1984-85, the department was several months late in preparing its monthly appropriation reconciliations. As a result, the department could not detect errors and discrepancies or rely on certain CALSTARS reports. In addition, because the department failed to enter all of its July 1, 1984, balances into the CALSTARS until July 1985, appropriation reconciliations of previous years were difficult to complete. The California Fiscal Information System Program budget manager in the Department of Finance attributes these weaknesses to the vacancy of key managerial or supervisory positions in the department's Accounting and Systems Bureau during the CALSTARS implementation period. As a result, incorrect decisions or no decisions were made on problems that arose. Also, according to the budget manager, the new managers or supervisors filling the vacancies did not have sufficient CALSTARS training to provide guidance to the accounting staff.

Criteria: CALSTARS Procedures Manual, Volume II, Chapter VII, requires agencies to reconcile all appropriation balances with the State Controller's office monthly. Reconciliation procedures ensure that financial

transactions have been adequately processed and controlled and that the financial reports properly reflect the data recorded in the CALSTARS master files.

Recommendation: The department should reconcile appropriation balances at the end of each month.

Item 6. **Failure To Reconcile the CALSTARS Reports**

Finding: The department does not regularly reconcile its general ledger to the CALSTARS document reports. For example, the General Fund Due From Other Funds account balance in the June 30, 1985, document report exceeded the general ledger account balance by \$823,903.

Additionally, the department does not reconcile subsidiary reports for the general ledger accounts. For example, the June 30, 1985, Due to Other Funds subsidiary report for the Social Welfare Federal Fund does not agree with the corresponding Due From Other Funds subsidiary report in the State Expenditure Revolving Fund.

Criteria: CALSTARS Procedures Manual, Volume II, Chapter VIII, states that the document and subsidiary files are internal files maintained to support the general ledger. Therefore, reports generated from these files should be reconciled with the appropriate general ledger accounts or related subsidiary file.

Recommendation: The department, with the help of the Department of Finance, should incorporate program controls into the CALSTARS to provide better assurance that reports agree with each other. Until these controls are implemented, the department should reconcile the reports generated from the various CALSTARS files each month.

Item 7. **Reconciliations of Claim Schedules Are Not Prompt**

Finding: The department does not promptly reconcile its outstanding claim schedules with the Notice of Claims Paid from the State Controller's office at the end of each month. Failure to promptly perform monthly reconciliations of outstanding claim schedules prevents the detection of errors or irregularities. For example, the department failed to promptly record the payment of 13 claim schedules for the General Fund Program 20 (In-Home Supportive

Services). Approximately seven months passed before the department reported these claim schedules as being paid on the CALSTARS Document Report of Claims Filed. As a result, the Document Report of Claims Filed was overstated by at least \$10.2 million from August 1984 through March 1985.

Criteria: CALSTARS Procedures Manual, Volume II, Chapter III, states that the reconciliation of claim schedules should be performed at the end of each month. Reconciliations represent an important element of internal control because they provide a high level of confidence that transactions have been adequately processed and that the financial records are complete.

Recommendation: The department should promptly reconcile its outstanding claim schedules with the Notice of Claims Paid from the State Controller's office.

Item 8. Inadequate Cash Management

Finding: The department does not verify the availability of funds before it submits claim schedules to the State Controller's office for payment. Five claim schedules, totaling approximately \$8.8 million, were returned by the State Controller's office because of insufficient funds in the department's appropriation. As a result, the department delayed the payment of these claim schedules for 2 to 51 days and created additional work for both the State Controller's office and the department.

Criteria: Government Code Section 13401 requires each agency to maintain effective systems of internal accounting and administrative control to minimize error.

Recommendation: The department should ensure that its expenditure control unit verifies the availability of funds before it submits claim schedules to the State Controller's office for payment.

Item 9. Inadequate Control Over Changes Made to the CALSTARS Tables

Finding: The department's systems unit did not keep a "table maintenance log" (a record of changes made to the CALSTARS tables) throughout fiscal year 1984-85. In addition, all changes to the CALSTARS tables are not adequately supported. One role of the systems unit is to ensure the accuracy of the changes made to the

CALSTARS tables by comparing the activity reports with the related input documents. However, without a table maintenance log, it is difficult for the systems unit to research changes made to the tables. Also, inadequate supporting documentation and the lack of a formal process to reconcile the control log with the table maintenance output reports minimize assurance that changes to the tables are consistently and adequately controlled.

Criteria: CALSTARS Procedures Manual, Volume II, Chapter VI, states that a control log should be kept for all changes made to the CALSTARS tables. It also states that the various activity reports must be reconciled to the table maintenance log to ensure that each table is properly updated.

Recommendation: The department should keep a control log of changes made to the CALSTARS tables and reconcile that log to the activity reports in accordance with the CALSTARS Procedures Manual. In addition, the department should ensure that changes made to the CALSTARS tables are adequately documented.

Item 10. **Review of the CALSTARS Edit Activity Error Reports Is Not Prompt**

Finding: The department did not promptly review the CALSTARS Edit Activity Error Report during fiscal year 1984-85. In some cases, errors remained unresolved for over three months, causing reports to be misstated.

Criteria: CALSTARS Procedures Manual Volume II, Chapter II, states that all errors must be corrected as expeditiously as possible.

Recommendation: The department should implement procedures to ensure that the CALSTARS Edit Activity Error Reports are reviewed promptly.

Item 11. **Delays in Requesting Federal Reimbursement**

Finding: The State is losing interest earnings because the department does not promptly request federal reimbursement of funds expended from the State Expenditure Revolving Fund. Delays in requesting federal reimbursement occurred from July 1984 through March 1985 and ranged from approximately 19 to 84 days after the expenditure was made. In some instances, the department exceeded its grant

Criteria: Prudent fiscal management requires that interagency agreements be executed promptly so that the State can collect all reimbursements due from the federal government as soon as the State is entitled.

Recommendation: The department should promptly execute interagency agreements so that it can collect all reimbursements as soon as it is entitled.

Item 13. Collection of Statewide Cost Allocation Plan Reimbursements Is Not Prompt

Finding: The department did not promptly collect federal reimbursements for the federal share of service costs provided by central service agencies. The plan under which each state agency pays for its share of the State's costs for central services is called the Statewide Cost Allocation Plan (SWCAP), and the amount that agencies must remit to the General Fund is called the SWCAP reimbursement. The department delayed requesting SWCAP reimbursements for as long as one year after the reimbursements were collectable because it was unable to extract SWCAP reimbursement information from the CALSTARS until April 1985. The inability to identify this information delayed the collection of SWCAP reimbursements from the federal government. As a result, the General Fund lost potential interest earnings of approximately \$228,000.

Criteria: Government Code Sections 13332.01 and 13332.02 require individual agencies to recover SWCAP reimbursements from the federal government and to transfer the SWCAP reimbursements from agency funds to the General Fund promptly.

Recommendation: The department should ensure that recoveries of SWCAP costs are made promptly to maximize potential interest earnings.

Item 14. Inadequate Accountability Over Prepayments to Other Governments

Finding: The department inadequately accounted for Prepayments to Other Governments at June 30, 1985, in the Social Welfare Federal Fund. The department did not liquidate an advance of approximately \$83.4 million made for fiscal year 1983-84 to counties for the Assistance Payments-Maintenance grant when it received final expenditure reports. In

addition, the department failed to properly report in the financial statements of the Social Welfare Federal Fund the advance of approximately \$84.8 million that was outstanding at June 30, 1985, and a loan from the General Fund that was made on June 28, 1985, to cover this advance. As a result, the Due to Other Funds account in the Social Welfare Federal Fund is understated by approximately \$84.8 million for the outstanding loan from the General Fund. Also, the Prepayments to Other Governments account in the Social Welfare Federal Fund is understated by approximately \$1.4 million (\$83.4 million less \$84.8 million).

Criteria: The Prepayments to Other Governments account represents advances made to counties for the Assistant Payments-Maintenance grant. Each advance remains on the department's records until a county submits a final expenditure report. At that time, the department should liquidate the advance. Also, all loans outstanding from the General Fund, as of June 30, should be reported as Due to Other Funds.

Recommendation: The department should ensure that the necessary liquidations of prepayments are made at the proper time and that the advances and loans outstanding at June 30 are accurately reported in the financial statements.

Item 15. Failure To Reconcile the Department's Cash Records With Centralized Treasury System's Statements

Finding: The department does not promptly and properly reconcile its cash balance to the bank statement from the centralized State Treasury System at the end of each month. Delays in preparing the bank reconciliations ranged from two months to eight months. For example, the department did not resolve differences totaling \$562,915, between the State Treasury System's bank balance and the CALSTARS revolving fund cash balance for April 1985 until September 1985. In addition, there were no signatures on the monthly bank reconciliations showing that management had reviewed them. Failure to reconcile cash records and to properly review monthly bank reconciliations can result in the misstatement of cash balances and may prevent the detection of errors and irregularities such as unauthorized disbursements or failures to deposit money.

Criteria: State Administrative Manual Section 8060 requires state agencies to promptly reconcile their end-of-month bank statement from the State Treasury System. State Administrative Manual Section 7908 requires the reconciliation to include both the preparer's and the reviewer's names.

Recommendation: The department should reconcile its records with the bank statement from the State Treasury System promptly at the end of each month. Both the preparer and a reviewer from management should sign the reconciliation.

Item 16. **Failure To Reconcile the Department's Cash Records With the State Controller's Records**

Finding: The department does not promptly and properly reconcile its Cash in State Treasury account balance for the Social Welfare Federal Fund to the State Controller's Fund Reconciliation Report at the end of each quarter. On June 30, 1985, the department's Cash in State Treasury account balance differed from the State Controller's Fund Reconciliation Report by approximately \$41,000. In addition, the June 30, 1985, reconciliation was not prepared until December 30, 1985. Failure to reconcile the Cash in State Treasury account balance can result in the misstatement of the cash balance and prevent the early detection of irregularities such as unauthorized or excessive disbursements.

Criteria: State Administrative Manual Section 7910 requires state agencies to verify the balance of their Cash in State Treasury accounts with the matching accounts in the State Controller's office at the end of each quarter.

Recommendation: The department should reconcile its Cash in State Treasury account balance with the State Controller's Fund Reconciliation Report promptly at the end of each quarter.

Item 17. **Inadequate Listing of Outstanding Checks**

Finding: The department does not maintain an accurate listing of outstanding checks to support the amount attributed to outstanding checks that it reports in the monthly bank reconciliation of the centralized State Treasury System account. Because the department does not maintain an accurate listing of

outstanding checks, there is no assurance that the amount attributed to outstanding checks reported on the department's bank reconciliation is correct.

Criteria: State Administrative Manual Section 7967 requires that the amount attributed to outstanding checks reported in monthly bank reconciliations be supported by detailed listings that show the number, date, and amount of each outstanding check.

Recommendation: The department should prepare detailed listings of outstanding checks to support the amount attributed to outstanding checks reported in its bank reconciliations.

Item 18. **Checks Outstanding Over Two Years**

Finding: The department has many checks outstanding over two years totaling \$8,879. These checks must be reviewed each month when a bank reconciliation is prepared. This review is unnecessarily cumbersome and time-consuming and serves no useful purpose.

Criteria: State Administrative Manual Section 8042 requires that checks outstanding over two years be cancelled and that the amount be remitted to the Special Deposit Fund as unclaimed monies.

Recommendation: The department should comply with State Administrative Manual Section 8042.

Item 19. **Failure To Take Advantage of Vendor Discounts**

Finding: The department failed to take advantage of vendor discounts during fiscal year 1984-85. According to the chief of the Expenditure Control unit, the department did not have staff available to review contracts for vendor discounts due to the problems associated with the CALSTARS conversion and implementation. As a result, the department lost at least \$10,407 for failure to take advantage of vendor discounts.

Criteria: State Administrative Manual Section 8113 states that agencies, to the greatest extent practical, will accumulate discounted invoices and pay such invoices weekly or less frequently than daily to the extent that they can do so without losing cash discounts.

Recommendation: The department should establish procedures to ensure that vendor discounts are appropriately taken.

Item 20. **Failure To Perform Required Audits**

Finding: The department does not perform required audits on some of the group homes that accept children whose placement is funded under the Aid to Families with Dependent Children-Foster Care (AFDC-FC) program. On July 1, 1983, the department established payment rates for approximately 270 continuing (or regular) AFDC-FC group homes. As of July 1, 1985, the department had established payment rates for approximately 330 continuing (or regular) AFDC-FC group homes. According to the Chief of the Foster Care Rates Bureau, which is responsible for determining payment rates for group homes, approximately 270 audits should be completed by June 30, 1986. However, he said that the department will be unable to meet the requirements because only 163 audits of AFDC-FC group homes had been completed as of November 26, 1985. Few, if any, additional audits will be completed by June 30, 1986, because the department's audits section is being "phased out." According to the Chief of the Fraud and Audits Bureau, more audits were not completed because there was a lack of sufficient staff as a result of a hiring freeze and budgetary restrictions. Because the department will be unable to fulfill its audit responsibilities, it lacks assurance that the group homes are using state and federal funds for authorized purposes, and it may be jeopardizing the continuation of federal grant funds.

Criteria: Welfare and Institutions Code Section 11462 states that the department is to perform an audit at least once every three years beginning October 1, 1982, on all group homes that receive funds on behalf of children placed in the homes under the AFDC-FC program.

Recommendation: The department should ensure that audits of group homes are conducted at least once every three years as required.

Item 21. **Federal Financial Reports Are Not Reconciled to the Accounting Records**

Finding: The department did not reconcile its federal financial reports with departmental accounting

records for fiscal year 1984-85. Failure to reconcile federal financial reports to the accounting records can result in a misstatement of claims for cash advances and reimbursements from the federal government. It may also prevent the early detection of irregularities such as erroneous adjustments and nonreceipt of federal funds. We observed this same weakness during our financial audits for fiscal years 1982-83 and 1983-84. In a letter dated March 12, 1984, the department indicated that the adoption of the CALSTARS on July 1, 1984, would alleviate this weakness. However, according to the accounting officer for the Federal Reporting unit, the implementation of the CALSTARS created additional problems that the department has not been able to address.

Criteria: State Administrative Manual Section 20014 requires agencies receiving federal funds to reconcile federal financial reports to the official accounting records and retain all supporting schedules and worksheets for a minimum of three years.

Recommendation: The department should direct its accounting officer to ensure that federal reports are reconciled to the department's official accounting records.

Item 22.

Excess Federal Funds on Hand

Finding: The department's system of drawing down federal funds does not ensure that the federal disbursements are limited to the department's immediate needs. We reviewed approximately \$385 million in federal funds drawn down to pay local assistance expenditures for federal programs. Of the \$385 million that we reviewed, approximately \$13 million was drawn down and held for periods of 5 to 16 days before the State disbursed the money. In one instance, the department drew down federal funds to reimburse fiscal year 1983-84 expenditures which, if applied, would have exceeded its fiscal year 1983-84 budget authority as stated in the Budget Act of 1983. The department eventually applied these federal funds to claim schedules that were charged against the fiscal year 1984-85 appropriation. In other instances, the department held excess federal funds on hand for reasons that we could not determine. Maintaining "excessive cash" may result in the termination of advance financing by the federal government.

Criteria: Department of Treasury Circular 1075, Section 205.4, requires that "the timing and the amount of cash advances shall be as close as is administratively feasible to the actual disbursement by the recipient organization."

Recommendation: The department should establish procedures to ensure that drawdowns of federal funds are limited to the department's immediate needs.

Item 23. **Late Federal Financial Status Reports**

Finding: The department did not submit required federal financial status reports promptly. The department was late by 9 to 79 days in submitting quarterly Federal Financial Status Reports for six programs during fiscal year 1984-85. According to the Federal Reporting unit's accounting officer, California was granted an extension of the reporting requirement. However, the department could not provide us with written evidence of this extension. The department's failure to comply with reporting requirements may cause the U.S. Department of Health and Human Services to terminate the department's grant.

Criteria: Code of Federal Regulations, Title 45, Section 74.73, states that Financial Status Reports required on a quarterly basis are due 30 days after the reporting period.

Recommendation: The department should obtain written evidence of any extensions granted by the U.S. Department of Health and Human Services or implement procedures to comply with the Code of Federal Regulations.

Item 24. **Late Submission of Reports for the Food Stamp Program**

Finding: The department has not taken adequate steps to ensure that counties submit the Food Stamp Mail Issuance Report (FNS-259) to the U.S. Department of Agriculture-Food and Nutrition Service (USDA-FNS) promptly. For fiscal year 1984-85, 33 reports were 5 to 78 days late. Because the department has failed to comply with the Food Stamp Act, the USDA-FNS may, after written notification to the department, temporarily withhold some or all of the federal reimbursement of the State's costs of administering the Food Stamp Program. The manager of the Food Stamp Report unit believes that the

USDA-FNS is reluctant to impose sanctions against the State. Therefore, the department is reluctant to impose sanctions against the counties.

Criteria: Code of Federal Regulations, Title 7, Section 274.8, requires the USDA-FNS to receive the FNS-259 reports from the counties by the 45th day following the end of each quarter.

Recommendation: The department should ensure that the counties submit the Food Stamp Mail Issuance Report to the USDA-FNS by the 45th day following the end of each quarter as required.

Item 25. **Inaccurate Time-Reporting Summaries**

Finding: The department has made incorrect and unsupported financial charges to the following grants: Food Stamp, the Work Incentive Program (WIN), Assistance Payments-Maintenance Assistance, the Social Services Block Grant, and Refugee and Entrant Assistance. We identified incorrect and unsupported charges on time-reporting summaries in four of the seven units or bureaus we tested. For instance, the Employment Program Bureau undercharged the WIN grant by approximately \$7,400 during one month and overcharged this grant by approximately \$2,600 in a later month. Also, the Civil Rights Bureau did not retain documentation to support its time-reporting summaries for the entire 1984-85 fiscal year. In the examples we tested, the failure to maintain adequate time-reporting summaries has resulted in the loss of federal funds.

Because of inaccurate time-reporting summaries, we were unable to verify the department's compliance with the Code of Federal Regulations, Title 45, Section 224.16(b), that requires the State to assure a nonfederal cash or in-kind contribution of 10 percent of the cost of supportive services and related administrative expenses incurred by the State for the WIN program. As a result, the federal government may withhold grant monies.

Criteria: Federal Management Circular A-87, Attachment B, requires that salaries and wages of employees chargeable to more than one grant program or other cost objective be supported by appropriate time-reporting summaries.

Recommendation: The department should establish written procedures to maintain accurate time-reporting summaries for employees whose time is chargeable to more than one grant program.

Item 26. **Payments to Counties Exceeded Authorized Amounts**

Finding: The department paid counties' claims for overhead costs that exceeded amounts approved in the county Cost Allocation Plan (CAP). The State Controller's office is responsible for approving the county CAP, which limits the amount of county overhead costs that can be charged to the state and federal governments. Two counties were paid approximately \$102,985 more than the amounts approved in the county CAP. Because the department allows the counties to exceed the limits authorized by the State Controller's office, the federal government may terminate its grant award.

Criteria: Office of Management and Budget Circular A-87 stipulates the basic guidelines under which grant program costs are allowable. The costs must conform to established principles for the proper and efficient administration of the grant programs. The costs must also conform to limitations or exclusions set forth in federal laws or other governing limitations.

Recommendation: Before approving payments to counties for overhead costs, the department should ensure that claimed costs do not exceed costs approved by the State Controller.

Item 27. **Failure To Perform Financial and Compliance Audits of Subrecipients of the Refugee and Entrant Assistance Program**

Finding: The department has not complied with federal requirements to audit, biennially, subrecipients of the Refugee and Entrant Assistance Program. For the period from April 1, 1983, through June 30, 1985, the department entered into contracts totaling approximately \$27 million with approximately 60 subrecipients. According to the manager of the Employment Programs Bureau, as of November 26, 1985, the department had conducted only a few financial and compliance audits of these subrecipients. According to the Chief of the Fraud and Audits Bureau, the department was never budgeted with adequate staff positions to perform these financial

and compliance audits. Since the department has only audited a few of the subrecipients, the department lacks assurance that all subrecipients used the federal funds for authorized purposes. Further, because the department has failed to comply with federal requirements, it is jeopardizing the continuation of federal funds.

Criteria: Code of Federal Regulations, Title 45, Section 74.62, requires the department to ensure that subrecipients of Refugee and Entrant Assistance Program funds be audited at least every two years.

Recommendation: The department should assign the staff necessary or make other arrangements to ensure that subrecipients of Refugee and Entrant Assistance Program funds are audited biennially to comply with federal audit requirements.

Item 28. **Inadequate Monitoring of the Subrecipients Participating in the Refugee and Entrant Assistance Program**

Finding: During fiscal year 1984-85, the department failed to adequately monitor the performance of the approximately 60 contracts with subrecipients participating in the Refugee and Entrant Assistance Program. Although formal on-site monitoring of the contracts with subrecipients was conducted during fiscal year 1983-84, the department failed to continue its formal on-site monitoring during fiscal year 1984-85. One subrecipient, who was awarded a contract totaling approximately \$179,000, achieved only 29 percent of its contract goal. Without effective on-site monitoring, the department cannot ensure that the subrecipients have complied with federal regulations.

Criteria: Code of Federal Regulations, Title 45, Section 74.81, requires departments to monitor the performance of the subrecipients' activities to ensure that they are progressing toward the goals of the grant. In addition, U.S. Department of Health and Human Services memorandum dated August 1, 1984, states that on-site monitoring should be part of the primary focus of the State's monitoring effort.

Recommendation: The department should perform on-site monitoring of subrecipients each year.

Item 29.

Inaccurate Federal Report

Finding:

The department did not accurately prepare the June 30, 1985, Quarterly Statement of Expenditures for the Aid to Families With Dependent Children (AFDC) program. As a result of a clerical error, the department overstated the federal government's share of the county administration costs by \$50,000. Because of this overstatement, the federal grant award for the quarter ending September 30, 1985, is overstated by \$50,000. .

Criteria:

Code of Federal Regulations, Title 45, Section 74.61, requires the grantee's financial management system to provide accurate, current, and complete disclosure of the financial results of each grant program.

Recommendation:

The department should report the overstatement as an adjustment to the September 30, 1985, Quarterly Statement of Expenditures of the AFDC program.

STATE CONTROLLER

The Office of the State Controller administers 2 of the 34 federal programs we reviewed. They are the Shared Revenue grants, Federal Catalog Numbers 98.003 and 98.005.

Item 1. Late Payments Under the Long-Term Local Financing Act of 1984

Finding:

The Financial Accounting unit (unit) of the State Controller's office was late in making payments during fiscal year 1984-85 under the Long-Term Local Financing Act of 1984. Government Code Section 16110 et seq., and Revenue and Taxation Code Section 11005 authorize the apportionment of funds from the Special Supplementary Subvention program and the Motor Vehicle License Fee program. The unit was late in disbursing fiscal year 1984-85 monies under the Special Supplementary Subvention program to cities, redevelopment agencies, and special districts. The unit combined the first and second payments to the redevelopment agencies and special districts and made these payments in March and April of 1985; the unit made the third and final payment in August and September. The unit did not make any of the three payments to the redevelopment agencies and special districts by the required dates. Further, the unit paid the cities in March 1985, approximately four months after the required date.

Additionally, the unit was late in making apportionments, based on repealed personal property tax relief payments, from the Motor Vehicle License Fee Account to counties and to the cities qualified for these payments. The unit combined the first seven required monthly payments to the counties into a single payment in January 1985. Cities received their annual payments four months past the due date. Delay in receipt of payments creates cash flow and planning problems for the cities, counties, and local agencies.

The assistant chief of the Division of Accounting attributes the unit's inability to meet payment deadlines to a variety of reasons. He stated that some delay was caused by the fact that the Governor signed legislation authorizing the Long-Term Local Financing Act of 1984 on July 16, 1984, after the beginning of the fiscal year. Also, the Governor signed subsequent amendments to the initial

legislation approximately two months later, on September 25, 1984. The assistant chief also stated that the county auditors contributed to the delay by submitting reports late to the State Controller's office that were needed to compute payment amounts. Further, he stated that the unit did not receive additional staff until January 1985 to handle the increased workload of these new programs, and the unit did not consider the prompt payment to be a higher priority than other responsibilities. Finally, he stated that the actual information for supplemental roll revenues, a vital part of the payment computation, cannot be available by June 30, the due date of the third payment.

Criteria: Government Code Section 16112(b) requires that the State Controller's office make Special Supplementary Subvention payments to each nonenterprise special district, multi-county special district, or redevelopment agency in three installments each year: one payment on or before October 31, the second on or before February 28, and the third payment on or before June 30. The State Controller's office is required to pay each city on or before November 15 of each year.

Revenue and Taxation Code Section 11005 requires the State Controller's office to make apportionments based on repealed personal property tax relief payments from the Motor Vehicle License Fee account to certain cities in July of each fiscal year. Additionally, the section requires the State Controller's office to make monthly payments to the counties.

Recommendation: The State Controller's office should request that the Legislature extend the date for the third payment due date to permit a reasonable amount of time for the counties to report actual supplemental roll revenues for the year and for the State Controller's office to prepare prompt payments.

Item 2. **Failure To Transfer Fuel Tax Funds According to Dates Specified by State Law**

Finding: The unit did not transfer funds from the Motor Vehicle Fuel account to the Highway Users' Tax account by the date required by state law for 11 of the 12 months in fiscal year 1984-85.

Additionally, the Control Accounts unit transferred \$3,799,000 from the Motor Vehicle Fuel account to

the Department of Food and Agriculture Fund on September 4, 1985, 26 days earlier than the earliest payment date allowed by the Revenue and Taxation Code. Because the balance remaining in the Motor Vehicle Fuel account is transferred to the Highway Users' Tax account and the balance remaining in the Highway Users' Tax account is transferred to the State Highway account, the State Highway account did not receive \$3,799,000 for use during the month of September 1984 as it would have if the Control Accounts unit had followed state law. After we informed the Control Accounts unit's assistant fiscal control officer of the noncompliance with state law, he placed a directive in the reminder file instructing his staff to make the transfer during the required period.

Criteria: Revenue and Taxation Code Section 8353 requires the State Controller's office to transfer, by the twenty-eighth day of each month, the balance remaining in the Motor Vehicle Fuel account at the close of business on the twenty-third day of the same month to the Highway Users' Tax account in the Transportation Tax Fund.

Revenue and Taxation Code Section 8352.5 requires that, in the second quarter of each fiscal year, the State Controller's office also transfer from the Motor Vehicle Fuel account to the Department of Food and Agriculture Fund an amount equal to the estimate contained in the most recent report prepared jointly by the Director of Transportation and the Director of Food and Agriculture.

Recommendation: The Financial Accounting unit should comply with state law with regard to transfer dates when making the transfer from the Motor Vehicle Fuel account to the Highway Users' Tax account. In addition, the Control Accounts unit should ensure that the transfer is made during the specified time period.

Item 3. **The Schools Unit Did Not Reconcile Its Records to the State Treasurer's Office Reports**

Finding: The State Controller's office's schools unit did not reconcile amounts it recorded as bond interest and redemption paid by the General Fund for the State School Building Aid Fund to the Monthly Statement of Bond Interest and Redemption received from the State Treasurer's office. As a result, the schools unit did not detect an error in the recording of a \$2,480,526 General Fund interest payment for the

State School Building Aid Fund that was charged to the School Lease-Purchase Fund. During our fieldwork in December 1985, we brought the error to the attention of the schools unit, which subsequently corrected it.

Criteria: State Administrative Manual Section 7900 discusses the importance of making regular reconciliations. Reconciliations represent an important element of internal control because they provide a high level of confidence that transactions have been adequately processed and that the financial records are complete.

Recommendation: The schools unit should reconcile its records of the Monthly Statement of Bond Interest and Redemption paid by the General Fund for the State School Building Aid Fund with the monthly records received from the State Treasurer's office.

Item 4. **Failure To Maintain Records**

Finding: The Personnel and Payroll Services Division (PPSD) did not maintain source documents beyond 30 days to support the corrections that the PPSD initiated in its on-line personnel and payroll system. As a result, there is no documentation available to support the approval and authorization of the PPSD initiated corrections and thus no names by which to fix responsibility for the action taken. The chief of the PPSD estimates that these corrections represent less than one percent of the total volume of payroll transactions.

Criteria: Government Code Section 13403 states that the elements of a satisfactory system of internal accounting control shall include "a system of recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures."

Recommendation: The State Controller's office PPSD should retain documentation for the corrections that it initiates and processes long enough to resolve questions regarding those transactions.

Item 5. **Review of Internal Auditor Operations**

Finding: The Management Audits and Review Section (MARS) of the State Controller's office is, in general, performing its audits in compliance with the

Standards of the Professional Practice of Internal Auditing. However, we have identified areas in which it can improve its operations. When performing audit sampling, the MARS did not consistently document its procedures to define the population or to determine the sample size. When this documentation is not thorough, there is reduced assurance that the auditor's conclusion on the universe of transactions is correct. In addition, the MARS' three-year audit cycle does not provide for each of the State Controller's divisions to be audited in the two-year reporting periods required by State Administrative Manual Section 20010. As a result, the State Controller's office statement of positive assurance as to the adequacy of its internal controls is not supported by audit work that was performed during the reporting period.

Criteria:

An audit sampling plan should clearly document how the population was defined and how the sample size was determined. The written sampling plan should show how the auditor determined the completeness of the population, it should define the sampling unit, and it should define the period covered by the test. In addition, the sampling plan should include documentation that the acceptable risk of overreliance on internal control, the tolerable rate of error, the expected population deviation rate, and the effect of the population size were considered. State Administrative Manual Section 20010 requires a conclusion every two years on whether a department's system of internal control is adequate. In order to make this determination, the auditor would need to perform the required audit procedures during each two-year reporting period.

Recommendation:

The MARS should consistently document in sampling plans how it defined the population that it was going to test and how it determined the sample size that it was going to examine. In addition, it should perform the required audit work within each two-year reporting period.

Item 6.

Failure To Reimburse the Geothermal Resources Development Account When Required

Finding:

The Financial Accounting unit (unit) did not make the final payment of \$923,993 in fiscal year 1984-85 to reimburse the Geothermal Resources Development Account for undistributed federal geothermal revenues that the State received in past years. These revenues consist of royalty, rental, and bonus

payments for the lease of federal lands within the State under the federal Shared Revenue-Potash/Sodium Lease program.

The State Controller's office is required to distribute 40 percent of the funds in the Geothermal Resources Development Account to the counties from which the revenues were derived; the remainder must be equally divided between the Local Government Geothermal Resources Revolving Subaccount and the Renewable Resources Investment Fund. As a result of the failure to reimburse the Geothermal Resources Development Account in fiscal year 1984-85, the counties did not receive \$369,597 (40 percent of \$923,993) and the Local Government Geothermal Resources Revolving Subaccount and the Renewable Resources Investment Fund each did not receive \$277,198 (30 percent of \$923,993) that they were entitled to in fiscal year 1984-85. The State Controller's office made the final payment of \$923,993 in September 1985 after we brought attention to the problem.

Criteria: Public Resources Code Section 3820(c) requires the State to deposit, each fiscal year, up to \$2 million of the revenues the State receives from nongeothermal sources under Section 35 of the Mineral Lands Leasing Act of 1920 (30 USC Sec. 191) into the Geothermal Resources Development Account until the State pays back the entire amount that is owed to the account for geothermal revenues that it did not distribute in past years.

Recommendation: To prevent the recurrence of overlooked payments, the Financial Accounting unit of the State Controller's office should maintain a calendar for infrequent payments.

Item 7. **The State's Failure To Comply With Federal Law in the Distribution of Forest Resource Revenues**

Finding: The State did not comply with federal law in the disbursement of \$5,554 of revenues derived from timber products harvested from the Fort Ord military installation during federal fiscal years 1983 and 1984. In the absence of specific direction from the Legislature as to the disposition of these revenues, the State Controller's office Control Accounts unit deposited them in the General Fund. As a result, Monterey County, in which Fort Ord is situated, did

not receive the monies for the benefit of public schools and public roads as required by federal statute.

Criteria: United States Code Title 10, Section 2665(e)(2), specifies that the amount of revenues derived from timber products "shall be expended as the state Legislature may prescribe for the benefit of the public schools and public roads of the county or counties in which the military installation or facility is situated."

Recommendation: The State Controller's office, on behalf of the State, should request from the Legislature or Department of Finance the necessary authorization that would enable the State Controller's office to disburse revenues derived from timber products in compliance with federal statute.

Item 8. **Inequitable Apportionment of Interest Monies From Shared Revenue-Potash/Sodium Leases**

Finding: The State Controller's office did not equitably apportion interest monies received in fiscal year 1984-85 for the late disbursement of federal mineral lease revenues and the late payment of lease monies under the Shared Revenue-Potash/Sodium Lease program. The Financial Accounting Unit (unit) credited all the interest to the State School Fund rather than distributing the monies proportionately to all recipients of revenue who shared in the inconvenience of late disbursements. As a result, the State School Fund received approximately \$42,000 more than it should have, and the Geothermal Resources Development account and the Trona and Kern School Districts received approximately \$33,000 and \$9,000, respectively, less than they should have. The chief of the unit believed that, since the U.S. Department of the Interior could not identify the specific products or periods for which it made these interest payments, the revenues fall in the donation category that goes to the State School Fund.

Criteria: There are no state or federal laws that specify how interest payments should be distributed. In the absence of such laws, good accounting practice requires that revenue earned by a given source be credited to that source. In this instance, revenues earned by geothermal revenues, State School Fund revenues, and specific district revenues should be proportionately credited to all those sources and not to one source only.

Recommendation: The State Controller's office should allocate the interest revenues received as a result of late mineral lease payments on a more equitable basis, such as in proportion to revenues received by each recipient in the fiscal year for which the interest monies are paid.

Item 9. **Incorrect Recording of Federal Receipts in the Federal Trust Fund**

Finding: In November 1984, the Control Accounts unit incorrectly credited federal receipts of \$230,319 from the Shared Revenue-Grazing Land program to the account for Shared Revenue-Potash/Sodium Lease program. This error resulted in an overstatement of potash/sodium lease revenues and an understatement of grazing land revenues. After we brought this error to the attention of the Control Accounts unit, the responsible person corrected the posting.

Criteria: Good internal control requires that an agency maintain current and accurate accounting records.

Recommendation: The Control Accounts unit should review the recording of receipts to ensure that they are properly coded and correctly posted to the appropriate accounts.

Item 10. **Incorrect Apportionment of Federal and State Revenues**

Finding: The State Controller's office did not correctly apportion revenues from federal and state sources because the Financial Accounting Unit (unit) did not have an adequate system of review.

In May 1985, the unit found that it had overapportioned mineral lease revenues of \$4.6 million to the State School Fund from May 1984 through May 1985. As a result, the counties in which the revenues were earned did not have the use of their 40 percent share, and both the Local Government Geothermal Resources Revolving Subaccount and the Renewable Resources Development Fund lost the use of their 30 percent share for the period involved. The unit corrected the misallocation of funds in July and August 1985.

In addition, the unit did not distribute \$775 of miscellaneous mineral lease revenues until 11 months after it had been deposited in the Federal Trust

Fund. The State School Fund did not receive the revenues until August 1985, when we brought the existence of the undisbursed monies in the Federal Trust Fund to the unit's attention.

Further, the unit erred in the computation of apportionment amounts. The State Controller's office disburses 81.25 percent of the Motor Vehicle License Fees apportionment to cities and counties based on population and disburses 18.75 percent primarily to counties based on repealed personal property tax relief payments. The unit overallocated \$31,471 of Motor Vehicle License Fees to the population category of distribution in November 1984. The unit discovered the overallocation and attempted to change it in December. In so doing, the unit made an error. As a result, the property tax relief category did not receive \$5,900 to which it was entitled, and the population category received \$5,900 more than it was entitled. The unit corrected the error made in the December 1984 apportionment when we brought it to the unit's attention.

Finally, the unit underpaid mineral lease revenues to the Geothermal Resources Development Account. The unit corrected this error in the September apportionment when we brought it to the unit's attention.

Criteria: Good internal control requires that an agency has procedures to ensure that apportionments are properly determined and mathematically correct and that all available funds are promptly distributed.

Recommendation: The Financial Accounting unit should review the apportionment of state and federal funds to detect and correct errors.

Item 11. Inadequate Review of County Cost Allocation Plans

Finding: The Division of Local Government Fiscal Affairs (division) did not adequately review cost allocation plans that counties submitted for fiscal year 1984-85. The division did not perform comprehensive field reviews to determine if the costs reported in the county cost allocation plans were reasonable, allowable, or properly allocated. In addition, the division performed comprehensive desk reviews on only 12 of the 58 county cost allocation plans submitted by the counties; the remaining 46 plans received only a limited desk review. According to

the bureau chief, the review process no longer includes a comprehensive field examination because the Governor reduced the number of staff in the unit that performed these reviews by 5.5 positions in fiscal year 1983-84. If the division does not perform comprehensive field reviews, it has only limited assurance that counties are properly claiming indirect and central support service costs related to state and federally funded programs.

Criteria: Code of Federal Regulations, Title 45, Section 74.61(f), requires that procedures be established for determining the reasonableness, allowability, and allocability of costs in accordance with applicable cost principles.

Recommendation: The Division of Local Government Fiscal Affairs should implement procedures to ensure that county cost allocation plans receive adequate review.

STATE TREASURER

Item 1. Reconciliations of Securities Held by Depositories Are Not Prepared Promptly

Finding: The State Treasurer's office took eight months to reconcile its March 31, 1985, balance of the State's security account with the amounts reported by depositories. This delay resulted primarily because a depository reported state security holdings in a new format that was not acceptable to the State Treasurer's office and because the State Treasurer's office was denied approval to hire additional staff to solve the reconciling problems. Failure to promptly reconcile accounts can result in the misstatement of securities balances and may also prevent the early detection of irregularities such as unauthorized security releases or the failure to deposit securities. As of January 17, 1986, the records of the State Treasurer's office were not reconciled with the depositories' records through June 30, 1985.

Criteria: Proper internal controls require that accounts be reconciled promptly.

Recommendation: The State Treasurer's office should reconcile monthly its records of securities deposited with its depositories with the depositories' records. Also, management should review the reconciliation to ensure that it is prepared monthly. Further, management should take appropriate action to investigate and resolve differences between the State Treasurer's office records and the depositories' records.

Item 2. Income Taxes Erroneously Withheld Were Not Promptly Collected

Finding: The State Treasurer's office has not collected approximately \$1,083,000 of income taxes erroneously withheld by financial institutions during calendar year 1984 from the State's interest income. The financial institutions erroneously withheld taxes on the interest income even though the State is exempt from federal taxation. The financial institutions withheld the taxes because some state departments failed to file forms that formally established their tax-exempt status by the date required. As a result, the Public Employees' Retirement System, the

State Teachers' Retirement System, the Legislators' Retirement System, and the State Compensation Insurance Fund are losing the use of approximately \$705,600, \$288,900, \$4,200, and \$84,700, respectively. The State Treasurer's office maintains accountability for these securities and the related interest earnings and was aware that the State had not yet received all of the interest it was owed.

Criteria: Good business practice dictates that the State promptly collect money that it is owed.

Recommendation: The State Treasurer's office should work with the departments involved to ensure that all interest due is promptly received.

Item 3. **Interest on Investments Not Promptly Collected**

Finding: The State Treasurer's office did not promptly collect approximately \$2,880,000 in interest due from three corporate bonds. In each case, the security broker from whom the State Treasurer bought the bonds erroneously received the interest amount due the State. The Chief of the Trust Services Division stated that this condition seldom happens and that it is industry practice to quickly correct the condition and not to charge the other party interest because sometimes and State of California benefits and sometimes the broker benefits. However in the cases of the three corporate bonds, the conditions were not quickly corrected. The State Treasurer's office did not promptly obtain the interest payment from the security broker because the State Treasurer's office did not have a system to ensure that collection problems are communicated to the division that can most effectively correct the problem.

Criteria: Good business practice dictates that the State promptly collect money that it is owed.

Recommendation: The State Treasurer's office should ensure that all interest due is promptly received by establishing effective collection procedures.

Item 4. **Interest Received Is Not Verified**

Finding: The State Treasurer's office does not determine if interest received from depositories is correctly computed. When cash is on deposit in a depository

pending the successful purchase of a security, the depository is supposed to pay the State interest at the daily Federal Fund rate less one-sixteenth of one percent. When the State Treasurer's office receives the interest, it does determine that the number of days that the cash was on deposit in the depository was correctly computed; however, it does not determine that the depository used the correct interest rate. Unless the State Treasurer's office verifies the number of days that the cash is on deposit, the interest rate, and the interest calculation, it cannot ensure that the State is receiving the amount of interest the State is owed.

Criteria: Good business practice dictates that the State verify that amounts owed are received.

Recommendation: The State Treasurer's office should obtain the daily Federal Fund rate and verify interest received to ensure that the State receives all interest that it is owed.

DEPARTMENT OF TRANSPORTATION

The Department of Transportation administers 2 of the 34 federal programs we reviewed. They are the U.S. Department of Transportation grants, Federal Catalog Numbers 20.205 and 20.500.

Item 1. Failure To Inform the State Controller of Financial Adjustments

Finding: During fiscal year 1984-85, the department did not submit to the State Controller monthly written requests for financial adjustments to the central accounting records of the State Highway Account (SHA). Instead of submitting the requests monthly as required, the department submitted only three requests each for ten of its appropriations, two requests each for two other appropriations, and one request each for three other appropriations. In addition, the department did not inform the State Controller of corrections made to remittance advices the department had previously submitted to the State Controller. The State Controller uses the remittance advices to credit certain reimbursements and federal funds to individual appropriations in the central accounting records of the SHA.

As a result of these two weaknesses, the department could not adequately reconcile the accounting records of the SHA to the State Controller's records throughout the fiscal year and at June 30, 1985. In its required year-end report, the Reconciliation of Agency Accounts with Transactions per State Controller, the department did not have detailed records to support a discrepancy of \$92.7 million in net reconciling items for the appropriations to the SHA. Since the State Controller relies primarily on the department's written requests or remittance advices to record expenditures, reimbursements, and federal funds in the SHA, the reconciling items represent adjustments made by the department to its own accounting records that were not communicated to the State Controller. Consequently, the department's records differed from the State Controller's records by the \$92.7 million in reconciling items.

Criteria: State Administrative Manual Section 8456 requires state agencies to submit monthly requests to the State Controller for financial adjustments to the central accounting records. In addition, State Administrative Manual Section 7957 requires state

agencies to reconcile unexpended allotments for each appropriation in the agency records to the appropriation balances in the State Controller's records at the end of each month.

Recommendation: The department should submit written requests monthly to the State Controller for financial adjustments to the central accounting records. In addition, the department should reconcile its accounting records monthly to the central accounts of the State Controller and resolve any differences between the two sets of records.

Item 2. **Failure To Prevent Overdrafts in the Revolving Fund**

Finding: The department exceeded the authorized limit for its office revolving fund in each of the last ten months of fiscal year 1984-85. For these ten months, the department overdrew its revolving fund checking account in the centralized State Treasury system by an average of \$10.8 million per month. When an agency overdraws its revolving fund balances, it is financing its activities with other agencies' monies.

We observed this same condition during our financial audit for fiscal year 1983-84. In a letter to our office dated April 1, 1985, the department indicated that it had made significant progress in dealing with this problem in the last four months of fiscal year 1983-84. However, the problem still existed in fiscal year 1984-85. Agency officials indicated that the \$6.1 million negative balance in the revolving fund at June 30, 1985, was caused by two primary factors. First, the department had a backlog of \$4.4 million in unreimbursed tort claims pending the approval of funding by the Department of Finance or release documents from the department's legal staff. Second, in June 1985, the department incorrectly recorded \$1.3 million in net disbursements for July 1985 revolving fund transactions (described further in Item 3 below). Government Code Section 948 effective January 1, 1986, authorizes the department to approve the funding for its own tort claims. As a result, agency officials expect to reduce the backlog of tort claims and, consequently, the negative balance in the revolving fund.

Criteria: State Administrative Manual Section 8047 directs agencies to make every effort to prevent overdrafts in their checking accounts.

Recommendation: The department should make every effort to prevent overdrafts in its revolving fund checking account. If the revolving fund advance is not adequate to finance the desired level of revolving fund activity, the department should seek approval from the Department of Finance to increase the amount of the advance.

Item 3. **Incorrect Recording of Cash Transactions**

Finding: The department incorrectly recorded certain cash disbursed in July 1985 as June transactions for General Cash and Revolving Fund Cash. In addition, the department recorded as deposits in the revolving fund in June 1985 those state warrants that reimburse the revolving fund and that were dated on or before June 30 but not received or deposited until July. The department also recorded certain cash disbursed in June 1985 as July transactions for Agency Trust Fund Cash. Because the department recorded these cash transactions in the incorrect months or accounts, the General Cash, Revolving Fund Cash, and Cash on Hand in Agency account balances were understated by \$6,300, \$1.3 million, and \$2.8 million, respectively. In addition, the Agency Trust Fund Cash account balance was overstated by \$44,300 at June 30, 1985.

Criteria: State Administrative Manual Section 8094 requires agencies to record checks written each day in the cash disbursement register. In addition, State Administrative Manual Section 7222 indicates that a cash disbursement register summarizes cash transactions for each month. Finally, State Administrative Manual Section 10586 requires agencies to include in the Cash on Hand in Agency account all state warrants that reimburse the revolving fund and that are dated on or before June 30 but not received or deposited until July.

Recommendation: The department should record all cash disbursements on the dates and in the months the disbursements are made. In addition, the department should record in the Cash on Hand in Agency account all state warrants that reimburse the revolving fund and that are dated on or before June 30 but not received or deposited until July.

Item 4.

Failure To Retain a Record of Outstanding Checks

Finding: The department did not retain a list to support the revolving fund checks outstanding at June 30, 1985, in the amount of \$12.9 million. As a result, the department could not support the revolving fund cash account balance at June 30, 1985.

Criteria: State Administrative Manual Section 7967 requires agencies to support the amount reported as outstanding revolving fund checks in their bank reconciliations by preparing a list showing check number, date, and amount of each outstanding check. In addition, State Administrative Manual Section 7951 requires agencies to retain the detail that supports the general ledger account balances for use by the auditors of the Department of Finance and the Office of the Auditor General.

Recommendation: The department should prepare a list of revolving fund checks outstanding at fiscal year end. In addition, the department should retain the list to support the amount reported in the bank reconciliation and to meet internal and external requirements.

Item 5.

Inadequate Review of Contract Retention Claims

Finding: The supervisor of the Disbursing Office-Contractors, which is accountable for monies withheld from progress payments (contract retentions), did not verify amounts to be paid to escrow agents or contractors before certifying claim schedules submitted to the State Controller for the disbursement of contract retentions. The supervisor certified claim schedules that resulted in the State Controller's disbursing \$595,000 more in contract retentions than should have been paid. As a result, the department lost its immediate financial recourse in the event of contractor default. The escrow agents or contractors have since returned the incorrect payments to the department, and the department provided them with the correct payment.

Criteria: Public Contract Code Section 10261 requires departments to retain a portion of progress payments to be made to contractors to ensure performance under the contract and to cover the value of unused materials. The department's accounting manual Chapter 10, Section 3.6, requires the department to base its payment for contract retentions upon amounts reflected in the progress payment vouchers.

Recommendation: The department should require the supervisor of the Disbursing Office-Contractors to review the accuracy of claims before certifying the claims to the State Controller for the disbursement of contract retentions.

Item 6. **Inadequate Control Over Contract Retentions**

Finding: The department did not determine that the market value of securities placed in escrow by contractors was sufficient to allow substitution of the securities for contract retentions. Public Contract Code Section 10263 permits contractors to substitute securities for the contract retentions; however, we found that the department released \$200,000 in contract retentions when the escrow agent was not holding securities sufficient to substitute for the contract retentions. When the department does not determine the market value of the securities, it exposes the State to a greater loss than would normally be incurred in the event of default by the contractor.

Criteria: Public Contract Code Section 10261 requires public agencies to retain a portion of the progress payments made on a contract to ensure performance under the contract and to cover the value of any unused materials. Under the provisions of the escrow agreement, the department is required to make payments of contract retentions to escrow agents only if the agent holds securities with a market value sufficient to allow substitution for the contract retentions.

Recommendation: Before filing claims with the State Controller for the disbursement of contract retentions, the department should determine that securities held in escrow for a contractor have a market value sufficient to allow substitution of the securities for the contract retentions.

Item 7. **Inadequate Separation of Payroll Duties**

Finding: Employees who process attendance and other payroll documents at seven maintenance stations in the San Francisco district also receive and distribute payroll warrants. Unless these duties are separated, an employee could authorize a fictitious payment for personal use.

Criteria: State Administrative Manual Section 8580.1 requires that persons who receive payroll warrants, distribute payroll warrants to employees, or handle warrants for any other purpose should not also be authorized to process or sign payroll documents.

Recommendation: The department should assign the duties of handling payroll warrants to employees who do not certify or process payroll documents.

Item 8. **Failure To Close Out Completed Projects**

Finding: The department did not promptly submit final claims to the Federal Highway Administration (FHWA) to close completed construction, local assistance, and emergency relief projects. The FHWA must review and approve these final claims before projects can be considered completed and closed. After a project is closed, the department can disencumber unliquidated funds for use on existing or future projects. Agency officials estimated that the department could have disencumbered funds of \$14 million for construction projects and \$22 million for local assistance projects if these completed projects had been closed promptly. We reported a similar finding on the completed construction projects to the department in our audit of fiscal year 1982-83.

Criteria: The Federal Aid Highway Program Manual, Volume 1, Chapter 4, Section 6, Item 5, requires federal aid recipients to promptly submit final claims to the FHWA upon completion of projects.

Recommendation: The department should promptly prepare final claims on completed projects and submit the claims to the FHWA for approval to close out the projects.

Item 9. **Delays in Requesting Federal Reimbursements**

Finding: The department did not promptly request reimbursement from the federal government for cash disbursed for the Urban Mass Transportation Capital Improvement Grants-Handicapped and Elderly Program. The department submitted only three requests for reimbursement to the federal government during fiscal year 1984-85 for this program. As a result of not promptly requesting federal reimbursements, the department lost the use of the unreimbursed cash to fund existing projects and potential interest earnings of \$39,000 on the unrequested amounts.

Criteria: State Administrative Manual Section 8776.3 requires state agencies to bill receivables promptly after the recognition of a claim.

Recommendation: To maximize the State's interest earnings, the department should promptly request reimbursement from the federal government when the State disburses the monies for the federal program.

Item 10. **Failure To Adjust Service Center Rates**

Finding: The department has not reviewed and adjusted service center rates since it developed these rates in fiscal year 1982-83. Because these rates have not been reviewed to determine if they adequately represent the cost of providing services, the department either may not be maximizing federal reimbursements or may be overcharging the federal government for service center costs.

Service centers are certain units within the department that perform specific services that benefit individual projects and the department as a whole. The FHWA has allowed the department to charge the cost of three of these service centers directly to projects. Although the department has assigned the responsibility of monitoring service center rates, it has not developed all of the necessary reports or the specific procedures to properly review and adjust these rates.

Criteria: The Federal Aid Highway Program Manual, Volume 1, Chapter 4, Section 5, Paragraph 9, requires that service center rates charged to a project be of an average actual cost and that these rates be periodically reviewed and adjusted in each succeeding fiscal year to correct any overcharge or undercharge incurred in the preceding fiscal year.

Recommendation: The department should periodically review the service center rates and should adjust these rates annually.

Item 11. **Confirmations of Rental Agreements Are Not Conducted**

Finding: Our review of the department's Los Angeles district office revealed that the district's Right of Way office has not conducted all required confirmations of new tenants to verify the terms of their rental agreements, including the dates of occupancy, rental rates, and the amounts of deposits paid. According

to the Chief of the Property Management Branch, confirmations of rental agreement terms help to assure that tenants have not paid to department employees any money in addition to that required by the rental agreement.

The accounting office had been conducting its confirmations but, in hopes of obtaining more accurate and timely information, the accounting office revised its procedures during the time of our review. The Right of Way office has not been totally fulfilling its responsibilities. We reviewed the files for 10 transactions for which the Right of Way office should have conducted confirmations, and found that the Right of Way office has conducted only 5 confirmations by interviewing tenants and by inspecting rental property. In addition, a junior Right of Way agent who conducts the confirmations indicated that there were approximately 35 confirmations that had yet to be conducted.

Criteria: The department's Right of Way Procedure Handbook (Volume 7 - Property Management) requires each district's Right of Way office to interview a sample of new tenants. The handbook also requires each district accounting office to contact a sample of new tenants by letter asking them to confirm rental data.

Recommendation: The department should require districts to adhere to the procedures for verifying rental agreement terms.

Item 12. Confirmations of Discharge of Accountability Are Not Conducted

Finding: Our review disclosed that the Los Angeles district accounting office has not conducted confirmations of amounts owed by tenants who have vacated state property, the purpose of which is to ensure that employees report all delinquent rents they collect. Because the district's accounting office has not conducted these confirmations, the department may not be able to identify unreported collections.

Criteria: According to the district's accounting manual (Section 2, Chapter 21), the accounting office should confirm amounts owed by tenants when the department writes off a debt that it has determined does not warrant further collection efforts.

Recommendation: The department should ensure that the Los Angeles district accounting office verify amounts owed by delinquent tenants.

Item 13. **Rental Agents Are Not Submitting Deposits Promptly**

Finding: Rental agents in the Los Angeles district office have not submitted cash receipts promptly. We reviewed a sample of ten cash receipts and found that two were not submitted to the district cashier within the required time period. In one instance, an agent submitted a cash receipt for \$1,200 eleven days after receiving the payment. The department loses interest on amounts not deposited. In addition, the department has less assurance that agents are properly safeguarding cash and that agents are not misusing funds.

Criteria: The department's procedures require that employees transmit cash received "without delay (within 24 hours, if possible)" to the district cashier or to another designated employee.

Recommendation: The department should enforce control procedures to ensure that cash receipts collected by rental agents are deposited promptly.

DEPARTMENT OF WATER RESOURCES

Item 1. Lack of Segregation of Duties Between Computer Operations and Data Control

Finding: Some computer operator duties are assigned to individuals who also have responsibility for monitoring computer operations. For example, the monitoring of the computer mainframe is assigned to data control technicians, and the individual who is responsible for monitoring the automated tape reservation system (data library) is also responsible for changing user passwords. These two control weaknesses could result in unauthorized changes to data files. These problems exist because the management of the department's electronic data processing (EDP) system has failed to recognize the incompatible functions assigned to the operations staff.

Criteria: State Administrative Manual Section 4846.5 requires the segregation of computer operation duties from all other EDP-related duties.

Recommendation: The department should reorganize the staffing of the EDP functions to provide adequate segregation between operations and data control.

Item 2. Inadequate EDP System Access Controls

Finding: The department has not adequately restricted access to its EDP system. System software programmers have unrestricted and unsupervised access to the computer room. In addition, the department maintains system, program, and data files on the floor of the computer room without restricting access to the files. This lack of adequate restriction could result in unauthorized manipulation of accounting, program, and system information.

Criteria: State Administrative Manual Section 4846.5 requires that access to master data files be limited to properly authorized individuals.

Recommendation: The department should develop and implement procedures for scheduling and supervising access of system programmers to the computer room, data files, and program files.

Item 3.

Inadequate Backup of EDP Software and Hardware

Finding: The department does not store all critical EDP history files at a remote location to ensure safekeeping in the event of an accident or natural disaster at the EDP facility. Also, the department does not have backup provisions to ensure continued processing if its EDP hardware becomes inoperative. In the event of accident or natural disaster, the department would have difficulty recreating billing information and financial statements. In addition, the loss of processing capacity could significantly affect the department's operations.

Criteria: State Administrative Manual Section 4845.81 requires that critical files be stored at an off-site location or in a fire-resistant safe. Also, State Administrative Manual Section 4846.3 charges the department with the responsibility of providing recovery of data processing capacity in the event of an accident or natural disaster.

Recommendation: The department should store production history files at an off-site location or in a fire-resistant safe and establish backup hardware provisions to ensure continued processing in the event of an accident or natural disaster.

Item 4.

The Internal Audit Office Does Not Comply With the Internal Auditing Standards

Finding: Management of the Internal Audit Office (office) has not established policies and procedures to comply with the "Standards for the Professional Practice of Internal Auditing," as adopted by the Institute of Internal Auditors, Inc. Some of our more significant findings were that there is no formal audit charter outlining the purpose, authority, and responsibility of the office; formal audit plans and procedures for each assignment are not documented; and the audit work is not adequately documented. Therefore, workpapers do not adequately support conclusions.

Criteria: Government Code Section 1236 requires state agencies that conduct internal audit activities to use the "Standards for the Professional Practice of Internal Auditing," of the Institute of Internal Auditors, Inc.

Recommendation: The department should ensure that the office complies with Government Code Section 1236 by having its management establish policies and procedures that are consistent with the "Standards for the Professional Practice of Internal Auditing," of the Institute of Internal Auditors, Inc.

Item 5. Inadequate Control Over Appropriations for Federal and State Projects

Finding: The department has not adequately controlled the amount of expenditures related to several federal and state projects. As a result, the department violated state law that prohibits making expenditures in excess of a budget appropriation. As of June 30, 1985, the department had spent \$321,844 from the Water Resources Revolving Fund (WRRF) on behalf of the Federal Trust Fund and \$323,794 on behalf of the General Fund for which it could not get reimbursed because their appropriations had been exhausted. The problem arose because the department makes the expenditures initially from the WRRF and then reimburses the WRRF through transfers from the Federal Trust Fund and the General Fund. However, the department exercises budgetary control over these expenditures only when it makes the monthly transfer to reimburse the WRRF rather than when it initially commits the resources. The department failed to recognize that it had overcommitted the allotments and did not ask the Department of Finance for a budget augmentation.

We reported a similar finding in the management letter for the fiscal year 1983-84. The department commented on March 8, 1985, that it agreed with the findings and that adequate allotment controls were in place.

Criteria: Section 32 of the annual budget acts prohibits any officer from making an expenditure in excess of an appropriation without the prior written consent of the Department of Finance. In addition, Government Code Section 13324 states that a person who makes an expenditure in excess of the budget allotments shall be personally liable for the excess amount.

Recommendation: The department should work with the Department of Finance to receive the additional spending authorization or with the Board of Control to write off the claims against the Federal Trust Fund and the General Fund. In addition, the department

should implement a system that allows the monitoring of all planned expenditures, so that overspending of allotments will be avoided in the future.

Item 6.

Incorrect Accrual Entry for Deferred Charges

Finding:

The department understated the balance of the Deferred Charges account in the California Resources Development Bond Fund by \$32.7 million at June 30, 1985, and overstated the related expense account by that amount. The department has to prepare financial statements on December 31 and on June 30 of every year for the benefit of the bondholders and state government, respectively. The preparation of the financial statements requires full accrual adjustments every six months. The department's accountant erroneously made the accrual adjustment at June 30, 1985, for a 12-month period rather than a 6-month period, thus overstating the Operating and Maintenance Expense account and understating the Deferred Charges account. As a result, the department submitted incorrect financial statements to the State Controller.

Criteria:

Generally accepted accounting principles require that expenses reflect only the period to which they pertain. To avoid errors in accounting and financial reporting, Government Code Section 13403 states that agencies should have an effective system of internal review as one element of a satisfactory system of internal control.

Recommendation:

The department should review all accrual entries to ensure that the account balances reflect only the activity for the period reported.

Item 7.

Late Financial Reports

Finding:

The department submitted the financial reports for its enterprise funds to the State Controller an average of two months after the due date. Failure to submit financial reports on time delays the State Controller in compiling complete financial statements for the State of California.

Criteria:

State Administrative Manual Section 7990 requires agencies to submit financial reports for nongovernmental cost funds by August 20.

Recommendation:

The department should submit its financial reports to the State Controller by the dates specified in the State Administrative Manual.

**REPORT ON COMPLIANCE
WITH FEDERAL GRANT REQUIREMENTS**



Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General

660 J STREET, SUITE 500
SACRAMENTO, CA 95814

Thomas W. Hayes
Auditor General

**Members of the Joint Legislative Audit Committee
State of California**

We have examined the General Purpose Financial Statements of the State of California for the year ended June 30, 1985, and have issued our report dated December 20, 1985. We made our examination in accordance with generally accepted auditing standards; the provisions contained in the U.S. Comptroller General's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, as they pertain to financial and compliance audits, and the provisions of the Office of Management and Budget (OMB) Circular A-128, Audits of State and Local Governments. Certain grant programs administered by the State of California were not included in the compliance supplement. For those programs, we reviewed the grant awards and applicable federal regulations to determine the major compliance requirements to be tested. Our examination included tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The scope of our examination did not extend to programs administered by the University of California. The University of California contracts with independent CPAs for a financial and OMB Circular A-110 audit. Results of the University's Circular A-110 audit are not included in this report. In addition, our examination of charges made by subrecipients of federal funds was limited to a review of the State's system for monitoring these subrecipients. Some subrecipients, such as local school districts and certain cities and counties, have Circular A-128 audits performed by independent auditors.

In our opinion, except as discussed in the following paragraph, the State of California complied with the terms and conditions of its grant awards and applicable federal regulations for the transactions tested in all material respects. Further, nothing came to our attention that would indicate that the State did not comply with the terms and conditions of its grant agreements and applicable federal regulations in all material respects for the transactions not tested.

Our examination did reveal some instances of noncompliance with terms and conditions of grant awards and applicable federal regulations. We discuss the instances of noncompliance on pages 63 through 207 of our report. We also present recommendations to remedy the instances of noncompliance and management's comments regarding the recommendations.

A summary schedule of federal assistance for the year ended June 30, 1985, is included on page 215 of this report. The schedule of federal assistance shows the amount and type of federal funds received by the State of California for the year ended June 30, 1985; it also shows which grants we reviewed. In our opinion, the schedule of federal assistance is fairly stated in all material respects in relation to the General Purpose Financial Statements.

In addition to the work we performed for the Circular A-128 audit, we performed other reviews related to federal programs. A schedule of the pertinent reports issued from July 1, 1984, through December 31, 1985, is included in Appendix B of this report.

OFFICE OF THE AUDITOR GENERAL



CURT I. DAVIS, CPA
Deputy Auditor General

February 14, 1986

**STATE OF CALIFORNIA
SCHEDULE OF FEDERAL ASSISTANCE
FOR THE FISCAL YEAR ENDED JUNE 30, 1985**

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Aging, Department of:		
Food Distribution	10.550	\$ 10,028,302
Special Programs for the Aging-- Title III, Parts A and B-- Grants for Supportive Services and Senior Centers	13.633	59,174,974 A
Special Programs for the Aging-- Title IV--Training, Research, and Discretionary Projects and Programs	13.668 (13.634)* (13.637)*	66,328 203,791
Senior Community Service Employment Program	17.235	4,888,184
Foster Grandparent Program	72.001	11,213
Senior Companion Program	72.008	8,727
Aging, Commission On:		
Special Programs for the Aging-- Title III, Parts A and B-- Grants for Supportive Services and Senior Centers	13.633	187,000 A

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

O - Grants reviewed by the Office of the Auditor General in conjunction with various reports issued from July 1, 1984, through December 31, 1985. See Appendix B for a description of these reports.

S - Block grant audit activity monitored by the State Controller and reported to the Governor and State Legislature or grants reviewed by the State Controller during the fiscal year 1984-85.

* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Agnews State Hospital:		
Foster Grandparent Program	72.001	89,899
Air Resources Board:		
Air Pollution Control Program Grants	66.001	2,359,578
Alcohol and Drug Programs, Department of:		
Assistance Payments-- Maintenance Assistance	13.808	788,361
Alcohol and Drug Abuse and Mental Health Services Block Grant	13.992	33,982,663 A S
Arts Council, California:		
Promotion of the Arts--Artists-in-Education	45.003	144,575
Promotion of the Arts--State Programs	45.007	551,300
Boating and Waterways, Department of:		
Boating Safety Financial Assistance	20.005 (20.004)*	1,477,424 (569,664)

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>	
Camarillo State Hospital:			
Mental Health Clinical or Service Related Training Grants	13.244	28,792	
Foster Grandparent Program	72.001	71,570	
Child Development Programs, Governor's Advisory Committee on:			
Administration for Children, Youth and Families--Child Welfare Research and Demonstration	13.608	19,908	
Coastal Commission, California:			
Coastal Zone Management Program Administration Grants	11.419	2,943,952	S
Coastal Zone Management Estuarine Sanctuaries	11.420	940,730	
Energy Impact--Formula Grants	11.421	550,695	
Commerce, Department of:			
Economic Development--Support for Planning Organizations	11.302	29,095	
Economic Development--Public Works Impact Projects	11.304	114,219	

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Commerce, Department of:		
Special Economic Development and Adjustment Assistance Program-- Sudden and Severe Economic Dislocation or Long-Term Economic Deterioration	11.307	1,273,271
Special Economic Development and Adjustment Assistance Program-- Sudden and Severe Economic Dislocation	11.311	1,147,417
Conservation Corps, California:		
Other--U.S. Information Agency	82.999	21,739
Disaster Assistance	83.516 (83.300)*	98,180 A
Conservation, Department of:		
Non-Sale Disposals of Mineral Material	15.214	5,990
Geologic and Mineral Resource Surveys and Mapping	15.800	80,171
State Underground Water Source Protection--Program Grants	66.433	101,492
Research and Development-- Fission, Fossil, Solar, Geothermal, Electric, and Storage Systems	81.037	38,405
Renewable Energy Research and Development	81.087	74,909

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Conservation, Department of:		
State Disaster Preparedness Grants	83.505 (83.203)*	464
Controller, State:		
Other--U.S. Department of Interior	15.999	375,500
Other--U.S. Department of Treasury	21.999	10,177
Construction Grants for Wastewater Treatment Works	66.418	336,934
Shared Revenue--Forest Resource	98.003	44,110,947 A
Shared Revenue--Grazing Land	98.004	213,319
Shared Revenue--Potash/Sodium Lease	98.005	45,185,608 A
Corrections, Board of:		
Corrections--Technical Assistance	16.603	15,000
Corrections, Department of:		
Corrections--Technical Assistance	16.603	10,647
Other--U.S. Department of Justice	16.999	98,388

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

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* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>	
Council on Developmental Disabilities, State:			
Administration on Developmental Disabilities--Basic Support and Advocacy Grants	13.630	3,737,200	
Criminal Justice Planning, Office of:			
Preventive Health and Health Services Block Grant	13.991	465,000	S
Criminal Justice--Part D Formula Grants	16.530		
Part E--National Priority Program Grants	16.532 (16.502)*	75,000	
Juvenile Justice and Delinquency Prevention--Allocation to States	16.540	4,262,301	
Developmental Services, Department of:			
Administration on Developmental Disabilities--Special Projects	13.631	9,313	
Social Services Research and Demonstration	13.647	20,642	
Medicare--Hospital Insurance	13.773 (13.714)*	4,204,975	

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Developmental Services, Department of:		
Medical Facilities Construction-- Project Grants	13.887	69,412
Foster Grandparent Program	72.001	59,796
Economic Opportunity, Department of:		
Community Services Block Grant	13.665 (13.999)*	571,179 33,822,188 A S
Low-Income Home Energy Assistance	13.818 (13.816)*	92,868,918 A S
Weatherization Assistance for Low-Income Persons	81.042	6,053,139
Education, Department of:		
Food Distribution	10.550	6,806,440
School Breakfast Program	10.553	51,669,915 A
Equipment Assistance for School Food Service Programs	10.554	(78,077)
National School Lunch Program	10.555	287,293,693 A
Special Milk Program for Children	10.556	(21,617)
Child Care Food Program	10.558	43,281,882 A O
Summer Food Service Program for Children	10.559	(16,512)
State Administrative Expenses for Child Nutrition	10.560	5,027,586

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Education, Department of:		
Nutrition Education and Training Program	10.564	(144,668)
Other--U.S. Department of Agriculture	10.999	69,850
Other--U.S. Veterans Administration	64.999	918,548
Toxic Substances Research Grants	66.507	55,760
Adult Education--State-Administered Program	84.002	6,654,431
Bilingual Education	84.003	802,061
Civil Rights Technical Assistance and Training	84.004	593,523
Education of Handicapped Children in State Operated or Supported Schools	84.009	1,726,155
Educationally Deprived Children--Local Educational Agencies	84.010	217,849,227 A
Migrant Education--Basic State Formula Grant Program	84.011	63,675,408 A
Educationally Deprived Children--State Administration	84.012	3,283,605
Neglected and Delinquent Children	84.013	2,860,977
Handicapped Early Childhood Education	84.024	17,688
Deaf-Blind Centers	84.025	839,033
Handicapped Preschool and School Programs	84.027	113,100,862 A
Special Education Personnel Development	84.029	626,283
Public Library Services	84.034	7,003,089
Interlibrary Cooperation	84.035	1,525,791

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Education, Department of:		
Vocational Education--Basic Grants to States	84.048	50,918,418 A
Vocational Education--Consumer and Homemaker Education	84.049	2,785,674
Vocational Education--Program Improvement and Supportive Service	84.050	10,044,919
National Vocational Education Research	84.051 (13.502)*	162,832
Vocational Education--Special Programs for the Disadvantaged	84.052	1,081,761
Career Education	84.074	76,816
Instructional Material and School Library Resources	84.088	(7,702)
Improvement in Local Educational Practice	84.089	(101,932)
Basic Skills Improvement	84.105	23,386
Migrant Education--Interstate and Intrastate Coordination Program	84.144	19,297
Transition Program for Refugee Children	84.146	5,162,607
Improving School Programs--State Block Grants	84.151	43,893,760 A
Library Services and Construction Act--Construction	84.154	2,408,700
Secretary's Initiative to Improve the Quality of Chapter 1, ECIA Projects	84.157	24,040
Handicapped-Special Studies	84.159	27,545

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>	
Education, Department of:			
Emergency Immigrant Education Assistance	84.162	12,777,992	
Other--U.S. Department of Education	84.999	27,160	
Emergency Medical Services Authority:			
Preventive Health and Health Services Block Grant	13.991	1,753,000	S
Emergency Services, Office of:			
Cooperative Forestry Assistance	10.664	87,467	
Civil Defense--State and Local Maintenance and Services	12.319	(1,529)	
Emergency Management Institute--Field Training Program	83.403	222,886	
Emergency Management Assistance	83.503 (83.200)*	5,560,498 1,263,807	
Other State and Local Direction, Control and Warning	83.504	191,471	
State Disaster Preparedness Grants	83.505	44,285	
Earthquake and Hurricane Preparedness Grants	83.506	297,243	
Radiological Instrumentation Facility Survey, Engineering and Development	83.508	413,921	
Radiological Protection Program	83.509 83.511	190,827 90,097	

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Emergency Services, Office of:		
State and Local Emergency Operating Centers	83.512	358,826
State and Local Warning and Communication Systems	83.513 (83.211)*	19,511
Population Protection Planning	83.514	321,146
Disaster Assistance	83.516 (83.300)*	46,738,949 A S
Employment Development Department:		
Food Stamps	10.551	(405,806)A
Work Incentive Program	13.646	15,793,161 A
Labor Force Statistics	17.002	2,035,067
Employment Service	17.207	81,224,255 A
Job Corps	17.211	1,087,136
Unemployment Insurance	17.225	203,162,070 A
Comprehensive Employment and Training Programs	17.232	(158,404) S
Disabled Veterans Outreach Program	17.801 (17.244)*	12,676,454
Employment and Training Assistance--Dislocated Workers	17.246	
Job Training Partnership Act	17.250 (17.999)*	259,173,148 A O
U.S. Department of Labor-- Federal Unemployment Benefits and Allowances	98.010	7,463,315

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Energy Resources Conservation and Development Commission:		
Solar Energy and Energy Conservation Bank	14.550 (14.507)*	402,840
Research and Development in Energy Conservation	81.035	171,393
State Energy Conservation	81.041	1,964,300
Appropriate Energy Technology	81.051	45,000
Fair Employment and Housing, Department of:		
Employment Discrimination-- State and Local Anti-Discrimination Agency Contracts	30.002	2,035,249
Fairview State Hospital:		
Foster Grandparent Program	72.001	161,447
Fish and Game, Department of:		
Cooperative Forestry Assistance	10.664	14,681
Other--U.S. Department of Agriculture	10.999	3,035
Anadromous and Great Lakes Fisheries Conservation	11.405	584,877

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Fish and Game, Department of:		
Commercial Fisheries Research and Development	11.407	33,675
Coastal Zone Management Estuarine Sanctuaries	11.420	16,500
Fisheries Development and Utilization Research and Development Grants and Cooperative Agreements Program	11.427	21,488
Other--U.S. Department of Commerce	11.999	522,324
Other--U.S. Department of Defense Training and Technical Assistance--Indian Tribal Governments	12.999	223,918
Small Reclamation Projects	15.143	1,902
Anadromous Fish Conservation	15.503	103,810
Fish Restoration	15.600	37,944
Wildlife Restoration	15.605	2,118,466
Endangered Species Conservation	15.611	4,849,811
Other--U.S. Department of the Interior	15.612	212,876
	15.999	1,295,098

Food and Agriculture, Department of:

Plant and Animal Disease and Pest Control	10.025	507,453
Market News	10.153	21,099
Federal-State Marketing Improvement Program	10.156	88,387
Inspection Grading and Standardization	10.162	119,562

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Food and Agriculture, Department of:		
Miscellaneous Federal Funds	10.199	153,660
Grants for Agricultural Research, Special Research Grants	10.200	14,697
Meat and Poultry Inspection	10.477	517,319
Agricultural Statistical Reports	10.950	35,680
Economic Development--Technical Assistance	11.303	4,500
Food and Drug Administration--Research	13.103	15,093
Pesticides Enforcement Program Grants	66.700	447,723 0
Other--U.S. Environmental Protection Agency	66.999	18,105
Forestry, Department of:		
Cooperative Forestry Assistance	10.664	495,417
Resource Conservation and Development	10.901	3,322
Other--U.S. Department of the Interior	15.999	1,639,720
Law Enforcement Assistance--Narcotics and Dangerous Drugs--Laboratory Analysis	16.001	800,000
Prevention and Suppression Agreement	98.015	115,476
Other--U.S. Department of Treasury	98.099	94,468
Miscellaneous Federal Funds	98.999	60,984

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Franchise Tax Board:		
Other--U.S. Department of Treasury	21.999	539
Fred C. Nelles School:		
Foster Grandparent Program	72.001	121,298
General Services, Department of:		
Minority Business Development-- Management and Technical Assistance	11.800	82,753
Public Works Employment Act-- Title I	98.006	97,881
Hastings College of the Law:		
College Work-Study Program	84.033	234,571
National Defense/Direct Student Loans	84.038	125,249
Health Services, Department of:		
Special Supplemental Food Program for Women, Infants, and Children	10.557	123,314,109 A S
Food and Drug Administration-- Research	13.103	591,791

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Health Services, Department of:		
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	13.116	297,797
Acquired Immunodeficiency Syndrome (AIDS) Activity	13.118	132,937
Childhood Immunization Grants	13.268	1,275,776
Centers for Disease Control-- Investigations and Technical Assistance	13.283	65,632
Biomedical Research Support	13.337	33,975
Cancer Cause and Prevention Research	13.393	70,863
Cancer Control	13.399	126,930
Medical Assistance Program	13.714	2,330,179,164 A O S
State Health Care Providers Survey Certification	13.777	7,274,767
Heart and Vascular Diseases Research	13.837	76,448
Microbiology and Infectious Diseases Research	13.856	316,798
Preventive Health Services-- Sexually Transmitted Diseases Control Grants	13.977	1,108,880
Preventive Health Services-- Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	13.978	86,500
Health Programs for Refugees	13.987	2,475,954
Cooperative Agreements for State-Based Diabetes Control Programs	13.988	270,381

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>	
Health Services, Department of:			
Preventive Health and Health Services Block Grant	13.991	4,126,215	S
Maternal and Child Health Services Block Grant	13.994 (13.232)*	17,308,448 215,440	S S
Mathematical and Physical Sciences	47.049	19,000	
Air Pollution Control--Technical Training	66.006	60,050	
Air Pollution Control--National Ambient Air and Source Emission Data	66.007	254,759	
Solid Waste Disposal Research Grants	66.504	126,590	
Safe Drinking Water Research and Demonstration Grants	66.506	1,486,114	
Toxic Substances Research Grants	66.507	86,707	
Hazardous Waste Management Financial Assistance to States	66.801	3,610,295	
Hazardous Substance Response Trust Fund	66.802	15,408,199	
Other--U.S. Environmental Protection Agency	66.999	263,315	
Other--U.S. Consumer Product Safety Commission	87.999	2,160	
Highway Patrol, California Department of:			
Highway Planning and Construction	20.205	44,725	A

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Highway Patrol, California Department of:		
State and Community Highway Safety	20.600	176,786
Other--U.S. Department of Treasury	98.099	25,176
Housing and Community Development, Department of:		
Economic Development--Support for Planning Organizations	11.302	33,334
Lower Income Housing Assistance Program	14.156	10,137,017
Community Development Block Grants/State's Program	14.228	27,414,379 A S
Community Development Block Grants/ Secretary's Discretionary Fund/ Technical Assistance Program	14.227 (14.229)*	10,033
Industrial Relations, Department of:		
Occupational Safety and Health	17.500	15,074,592 0
Mine Health and Safety Grants	17.600	175,173
Veterans Educational Assistance	64.111	247,914

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Justice, Department of:		
State Medicaid Fraud Control Units	13.775	3,870,081
Law Enforcement Assistance-- Part F--Discretionary Grants	16.531 (16.501)*	2,283,567
Lanterman State Hospital:		
Foster Grandparent Program	72.001	154,890
Maritime Academy, California:		
State Marine Schools Supplemental Educational Opportunity Grants	20.806	343,134
College Work-Study Program	84.007	53,514
National Defense/Direct Student Loans	84.033	16,290
Pell Grant Program	84.038	38,147
	84.063	182,623
Mental Health, Department of:		
Mental Health--Hospital Improvement Grants	13.237	473,353
Mental Health Clinical or Service Related Training Grants	13.244	291,212
Mental Health Disaster Assistance and Emergency Mental Health	13.982	862,431

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Mental Health, Department of:		
Alcohol and Drug Abuse and Mental Health Services Block Grant	13.992	13,684,095 A O S
Military Department:		
Other--U.S. Department of Defense	12.999	118,950
U.S. Department of Defense--Operating Reserve Guard Training	98.008	10,452,667
Miscellaneous Federal Funds	98.099	1,636,965
Miscellaneous:		
Shared Revenue--Flood Control	98.002	516,114
Miscellaneous Federal Funds	98.999	5,554
Miscellaneous Uncleared Collections	99.999	(4,437,053)
Motor Vehicles, Department of:		
State and Community Highway Safety	20.600	(909)
Other--U.S. Department of Transportation	20.999	26,438

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Napa State Hospital:		
Foster Grandparent Program	72.001	36,882
Northern Schools:		
Foster Grandparent Program	72.001	239,796
Occupational Informational Coordinating Committee, California:		
Vocational Education--Program Improvement and Supportive Service	84.050	102,180
Parks and Recreation, Department of:		
Comprehensive Planning Assistance	14.203	213,854
Historic Preservation Grants-in-Aid	15.904	1,205,107
Outdoor Recreation--Acquisition, Development and Planning	15.916	14,522,705
Disaster Assistance	83.516 (83.300)*	571,900 A (400,000)A
Planning and Research, Office of:		
Energy Extension Service	81.050	525,935

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Porterville State Hospital:		
Foster Grandparent Program	72.001	77,341
Postsecondary Education Commission, California:		
Fund for the Improvement of Post Secondary Education	84.116	34,940
Public Utilities Commission:		
Grants-in-Aid for Railroad Safety--State Participation	20.303	144,807
Gas Pipeline Safety	20.700	130,852
Rehabilitation, Department of:		
Rehabilitation Services--Basic Support	84.126	76,281,780 A
Rehabilitation Services--Service Projects	84.128	198,609
Rehabilitation Training Centers for Independent Living	84.129	168,535
Other--U.S. Department of Education	84.132	440,076
	84.999	720,000
Seismic Safety Commission:		
Other--U.S. Federal Emergency Management Agency	83.999	380,106

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Social Services, Department of:		
Food Stamps	10.551	98,867,475 A
Administration for Children, Youth and Families--Child Abuse and Neglect Discretionary Activities	13.670 (13.628)*	452,687
Child Welfare Services--State Grants	13.645	23,847,762 A
Work Incentive Program	13.646	23,530,448 A
Administration for Children, Youth and Families--Adoption Opportunities	13.652	20,443
Social Services Block Grant	13.667 (13.642)*	290,912,522 A S
Child Support Enforcement	13.679	91,775,419 A
Health Financing Research, Demonstrations and Experiments	13.766	(1,287)
Social Security--Disability Insurance	13.802	73,383,262 A
Supplemental Security Income	13.807	22,446
Assistance Payments--Maintenance Assistance	13.808 (13.810)*	1,808,234,846 A 3,094,600 A
Assistance Payments--Research	13.812	160,706
Refugee and Entrant Assistance-- State Administered Programs	13.814 (13.813)*	181,389,303 A 297,903 A
Other--Dept. of Health and Human Services	13.999	40,893
Other--U.S. Federal Emergency Management Agency	83.999	41,061

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Sonoma State Hospital:		
Foster Grandparent Program	72.001	129,983
State Fire Marshal, Office of:		
Other--U.S. Federal Emergency Management Agency	83.999	10,000
State University, The California:		
Public Telecommunications Facilities	11.550	30,638
Other--U.S. Department of Defense	12.999	15,251
Occupational Safety and Health Research Grants	13.262	25,623
Professional Nurse Traineeships	13.358	113,198
Indian Education--Higher Education Grant Program	15.114	21,598
Aerospace Education Services Project	43.001	111,478
Management Assistance to Small Businesses	59.005	9,100
Veterans Educational Assistance	64.111	2,700
Other--U.S. Veterans Administration	64.999	2,258
College Library Resources	84.005	(890)
Supplemental Educational Opportunity Grants	84.007	7,197,044

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
State University, the California:		
Special Education Personnel Development	84.029	57,645
College Work-Study Program	84.033	9,424,108
National Defense/Direct Student Loan Cancellations	84.037	1,270,142
National Defense/Direct Student Loans	84.038	979,236
Pell Grant Program	84.063	46,806,312
Higher Education--Veterans' Cost of Instruction Program	84.064	42,619
Postsecondary Education Programs for Handicapped Persons	84.078	101,588
Indian Education--Fellowships for Indian Students	84.087	2,367
Graduate and Professional Study	84.094	21,000
Statewide Health Planning and Development, Office of:		
Medical Facilities Construction--Formula Grant	13.887 (13.220)*	54,009
National Health Service Corps Scholarship Program	13.288	128,108
State Health Planning and Development Agencies	13.293	2,012,803
Stockton State Hospital:		
Foster Grandparent Program	72.001	49,024

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Student Aid Commission:		
Higher Education Act Insured Loans	84.032	82,857,910 A 0
Grants to States for State Student Incentives	84.069	11,711,856
Traffic Safety, Office of:		
State and Community Highway Safety	20.600	11,165,373
Transportation, Department of:		
Other--U.S. Department of Agriculture	10.992	9,265
Other--U.S. Department of the Interior	15.999	160
Highway Planning and Construction	20.205	886,142,210 A S
Local Rail Service Assistance	20.308	222,261
Urban Mass Transportation Capital Improvement Grants	20.500	38,871,530 A
Urban Mass Transportation Managerial Training Grants	20.503	9,545
Urban Mass Transportation Technical Studies Grants	20.505	367,522
Public Transportation for Nonurbanized Areas	20.509	4,304,885
Other--U.S. Department of Transportation	20.994	1,341,765

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<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Transportation, Department of:		
Other--U.S. Department of Transportation	20.999	41,425
Other--U.S. Environmental Protection Agency	66.998	135
Appropriate Energy Technology	81.051	2,500
Trustees - Fiscal Management, Board of:		
Energy Conservation for Institutional Buildings	81.052	286,008
U.S. Department of Housing and Urban Development--Interest Reduction Construction	98.013	1,116,138
University of California:		
Other--U.S. Department of Agriculture	10.999	50,000
Veterans Home of California:		
Medicare--Hospital Insurance	13.773	3,686,372
Medicare--Supplementary Medical Insurance	13.774	1,810,526
Veterans State Domiciliary Care	64.014	1,686,501

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

O - Grants reviewed by the Office of the Auditor General in conjunction with various reports issued from July 1, 1984, through December 31, 1985. See Appendix B for a description of these reports.

S - Block grant audit activity monitored by the State Controller and reported to the Governor and State Legislature or grants reviewed by the State Controller during the fiscal year 1984-85.

* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Veterans Home of California:		
Veterans State Nursing Home Care	64.015	3,923,444
Veterans State Hospital Care	64.016	149,404
Vocational Education and Technical Training, California Advisory Council on:		
Vocational Education--State Councils	84.053	205,000
Water Resources, Department of:		
Flood Control Projects	12.106	3,333
Navigation Projects	12.107	38,081
Small Reclamation Projects	15.503	174,504
Wildlife Restoration	15.611	3,376
Water Resources Investigations	15.804	57,071
National Water Research and Development Program	15.505 (15.950)*	113
Water Resources Planning	65.001	53
Flood Insurance	83.100	186,287
Other--U.S. Department of Treasury	98.099	75,020

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

O - Grants reviewed by the Office of the Auditor General in conjunction with various reports issued from July 1, 1984, through December 31, 1985. See Appendix B for a description of these reports.

S - Block grant audit activity monitored by the State Controller and reported to the Governor and State Legislature or grants reviewed by the State Controller during the fiscal year 1984-85.

* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>	
Water Resources Control Board, State:			
Small Reclamation Projects	15.503	72,960	
Intergovernmental Mobility of Federal, State, and Local Employees	27.011	728,891	
Construction Grants for Waste- Water Treatment Works	66.418	178,577	S
Water Pollution Control--State and Interstate Program Grants	66.419	3,133,123	
Water Pollution Control--State and Local Manpower Program Development	66.420	60,229	
State Underground Water Source Protection--Program Grants	66.433	60,104	
Water Pollution Control--Lake Restoration Cooperative Agreements	66.435	523,261	
Construction Management Assistance Grants	66.438	6,725,088	
Water Quality Management Planning	66.454 (66.426)*	1,420,662	
Youth Authority, Department of the:			
Justice Research and Development Project Grants	16.560	234,079	
Corrections--Technical Assistance	16.603	22,313	

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

O - Grants reviewed by the Office of the Auditor General in conjunction with various reports issued from July 1, 1984, through December 31, 1985. See Appendix B for a description of these reports.

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* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

<u>State Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Monies Received</u>
Youth Authority, Department of the:		
Other--U.S. Department of Justice	16.999	441,693
Foster Grandparent Program	72.001	<u>8,891</u>
Total		<u>\$8,381,463,300</u>

A - Grants reviewed by the Office of the Auditor General for the fiscal year 1984-85, Circular A-128 compliance audit.

O - Grants reviewed by the Office of the Auditor General in conjunction with various reports issued from July 1, 1984, through December 31, 1985. See Appendix B for a description of these reports.

S - Block grant audit activity monitored by the State Controller and reported to the Governor and State Legislature or grants reviewed by the State Controller during the fiscal year 1984-85.

* The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the superseded federal catalog numbers.

APPENDIX A

REPORTS ISSUED BY THE
OFFICE OF THE AUDITOR GENERAL
JULY 1, 1984 THROUGH DECEMBER 31, 1985

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Jul 20	State Retirement Systems Are Paying Excessive Disability Benefits	P-375
Aug 07	The State Lacks Data Necessary To Determine the Safety of Pesticides	P-414
Aug 15	The State Can Increase Tax Assessments By Identifying Persons Who Earn Commissions but Fail To File Tax Returns	P-370
Aug 16	Public Pension Funds Are Not Complying With Statutory Requirements for Investing in California Residential Realty	P-403
Aug 28	Some Continuing Education Courses Do Not Meet State Requirements	P-439
Aug 30	State of California, Statement of Federal Land Payments, October 1, 1982 Through September 30, 1983	F-467
Sep 05	The Department of Mental Health Has Deficient Accounting and Grant Management Practices	P-364
Sep 20	Defaulted Loans Under the California Guaranteed Student Loan Program	P-380
Sep 24	Fire Departments' Compliance With Cal/OSHA Regulations for Protective Clothing and Equipment	P-416
Sep 27	A Review of County Construction Funds for Courthouses and Criminal Justice Facilities	P-436
Oct 03	Status Report: The State Loan to the Alameda County Superintendent of Schools	F-438

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Oct 16	The State's General Fund Has Not Recovered Over \$2 Million in Costs To Administer Federal Programs	F-406
Oct 18	A Review of Treatment Authorization Requests Before and After the Medi-Cal Reforms of 1982	P-444
Oct 29	Appropriateness of the Office of Telecommunication's Billing Rates for Telephone and Radio Services	P-479.1
Nov 08	The State Needs To Improve Its Preparation of Citations and Its Assessments of Penalties Against Nursing Homes	P-455
Nov 09	California Student Aid Commission, State Guaranteed Loan Reserve Fund, Financial Audit Report, Year Ended June 30, 1984	F-450
Nov 13	The State Department of Education's Termination and Closeout of Its Contract With the International Institute for Urban and Human Development	P-429
Dec 06	A Review of Four Counties' Administration of Their Special District Augmentation Funds	P-463
Dec 10	Analysis of Former Chairman of the Board of Prison Terms' Travel	P-468
Dec 10	Relocation of the San Francisco District Office of the Department of Conservation's Division of Mines and Geology	P-471
Dec 12	Follow-up Analysis of Director of General Services' Travel	F-485
Dec 13	Accounting for Telecommunication Costs, Verifying Telephone Service Charges, and Preventing Personal Telephone Calls	P-479.2
Dec 17	The Department of Parks and Recreation's Implementation of the Off-Highway Motor Vehicle Recreation Act of 1982	F-480

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Dec 17	A Review of the Financial Status of the Madera County Superintendent of Schools	P-457
Jan 03	The State's Diversion Programs Do Not Adequately Protect the Public From Health Professionals Who Suffer From Alcoholism or Drug Abuse	P-425
Jan 04	The State Lacks General Plans and Land Ownership Records for the State Park System and Does Not Collect All Lease Payments on Time	P-381
Jan 07	California Department of Highway Patrol's Expenditures and Revenue Sources Related to the 1984 Summer Olympic Games	F-477
Jan 08	A Review of the State Department of Education's Actions to Implement Auditor General Recommendations Made Between 1980 and 1984	P-459.1
Jan 15	An Analysis of the State Teachers' Retirement System's Hiring and Compensation of Its Executive Officer	P-498
Jan 31	State of California, Statement of Security Accountability of the State Treasurer June 30, 1984	F-446
Feb 07	The State Could Expedite the Approval of Regulations	P-482
Feb 20	State of California, Financial Report Year Ended June 30, 1984	F-400
Mar 04	Public Reports of Auditor General Investigations From January 1, 1984 Through December 31, 1984	I-517
Mar 06	A Review of Nursing Home's Costs	P-455.1
Mar 13	California Can Reduce State and County Expenditures for Medical Services to Children	P-478
Mar 14	The State's Mental Health System Could Be Operated More Cost-Effectively and Could Better Meet the Needs of Clients	P-441

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Mar 21	The Office of the State Architect Spent More Than Authorized for Some State Construction Projects	P-476
Mar 25	The State Committed \$50 Million To Build the South Geysers Geothermal Power Plant Without Assuring That Sufficient Steam Was Available	P-483
Mar 29	Status of the Transition to the New Medi-Cal Fiscal Intermediary Contract	P-228.7
Apr 08	The State's Expenditures for Land Acquisitions and Grants in the Santa Monica Mountains	P-454
Apr 11	The State of California Must Improve the Control of Its Financial Operation	F-469
Apr 16	An Analysis of the Deficiency in the 1984-85 State School Fund	P-530
May 09	Some of the State's Licensed Residential Facilities for Children Are Not Safe	P-448
May 23	The State Has Had Problems In Planning and Designing the San Diego Prison	P-519
May 29	The Agricultural Labor Relations Board's Administration of the Agricultural Labor Relations Act	P-466
Jun 03	Report on Audit of Health Facility Data Collection and Disclosure Systems	P-496
Jun 15	Funds Spent By the Los Angeles Olympic Organizing Committee on Behalf of the California Museum of Science and Industry	F-475
Jun 17	Automation Plans of the Employment Training Panel	F-505A
Jun 24	Automation Plans of the California Unemployment Insurance Appeals Board	F-505B

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Jun 24	Review of the Edgemoor Geriatric Hospital and the San Diego County Hillcrest Mental Health Facility	P-536.1
Jun 24	Review of the State Board of Optometry's Enforcement Program	P-456
Jun 26	Review of Two Health Care Facilities in San Diego County	P-536
Jul 15	Review of the Department of Transportation's Contract of the I-580 Interchange In Castro Valley	P-523
Jul 17	California's Automated Vehicle Registration System and Its Phone-Mail Appointment System Have Temporarily Inconvenienced Some Citizens	P-527
Jul 19	State of California, Statement of Federal Land Payments, October 1, 1983 Through September 30, 1984	F-552
Jul 29	1984/85 Annual Report	A-599
Aug 13	State Department of Education Surplus Property-Hardware Program Financial and Compliance Audit Report Years Ended June 30, 1983 and 1984	F-481
Aug 14	The State of California Could Better Protect Commercial Fishing Resources	P-488
Aug 20	The Department of Health Services' Involvement in the Cleanup of Hazardous Waste Sites	P-565
Sep 10	The State is Incurring Unnecessary Costs Through Ineffective State Vehicle Management	P-461
Sep 12	The State Could Have More Effectively Managed the Sale and Repair of Surplus Residential Property	P-494
Sep 16	Follow-up Information on the Department of Social Services' Administration of Child Abuse Prevention Programs	P-265.2

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Oct 08	Status Report: The State Loan To The Alameda County Office of Education	F-570
Oct 24	The Public Utilities Commission Could Trim Additional Millions From Telephone Company Rate Increase Proposals	P-356
Oct 28	Conversion of Bound Volumes in the State Library To Microform	P-513
Nov 07	A Review of the Public Utilities Commission's Regulation of Passenger Vehicle Operations	P-562
Nov 21	California Student Aid Commission State Guaranteed Loan Reserve Fund, Financial Audit Report, Years Ended June 30, 1984 and 1985	F-556
Nov 27	The Department of Fish and Game Is Not Collecting All Revenues Owed To the State	P-546
Dec 02	Better Administration At the Department of Veterans Affairs Can Improve Services To Veterans	P-548
Dec 13	The Short-Term General Fund Loan of the Unemployment Compensation Disability Fund	P-430.1
Dec 30	The Board of Osteopathic Examiners Improperly Spent State Money To Support Its Legal Action Against Seating Two Public Members	F-561

**SCHEDULE OF AUDIT REPORTS
INVOLVING FEDERAL GRANTS
JULY 1, 1984 TO DECEMBER 31, 1985**

From July 1, 1984, to December 31, 1985, the Office of the Auditor General issued a number of reports on audits involving federal grants. The following schedule lists the reports issued and presents a summary of the report findings. The agencies' responses to these findings are included in each of the separate audit reports.

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant</u>	<u>Report Title and Description</u>
State Department of Education	Child Care Food Program	The State Department of Education's Termination and Closeout of Its Contract With the International Institute for Urban and Human Development (P-429, 11-13-84)
		(1) The San Diego Unified School District secured a judgment against the institute for the unpaid rent and utilities and demanded that the institute vacate the property used for its child development center. Because the institute had to remove its center from the school district's property, the department believed that the institute could no longer comply with the provisions of its child development contract.
		(2) The department terminated its contracts with the institute and contracted with the San Diego YMCA to provide child development services for the children who had been enrolled in the institute's child development program.
	Job Training Partnership Act	A Review of the Financial Status of the Madera County Superintendent of Schools (P-457, 12-17-84)
		(1) The Madera County Superintendent of Schools has budgeted expenditures for fiscal year 1984-85 that are \$531,903 greater than its budgeted income. The \$531,903 excess of expenditures over income includes \$293,471 for special purpose projects such as administering the Job Training Partnership Act. The superintendent will finance the deficit in its budget by using reserves from previous fiscal years.
		The Madera County Superintendent of Schools used the proper funds to finance the operation of its computer services, properly accounted for its computer services, and followed the provisions of the Education Code in purchasing computer equipment.

Agency Receiving Federal Funds

Federal Grant

Report Title and Description

Surplus Property-Hardware Program

State Department of Education Surplus Property-Hardware Program Financial and Compliance Audit Report, Years Ended June 30, 1983 and 1984 (F-481, 8-13-85)

(1) The Auditor General issued a disclaimer of opinion on the financial statements of the Surplus Property-Hardware Program because of problems in auditing transactions that the State Department of Education allocated to the program level.

(2) The State should maintain better control of participant eligibility and inventory of federal surplus property, should ensure that federal Quarterly Donation Reports reflect accurate and consistent information to the federal government, and should maintain adequate support for the account balances of the Hardware Program.

Department of Food and Agriculture

Pesticides Enforcement Program Grants

The State Lacks Data Necessary To Determine the Safety of Pesticides (P-414, 8-7-84)

(1) The State has no assurance that the Department of Food and Agriculture receives sufficient data on health studies to prevent the registration of unsafe pesticides.

(2) The department has not implemented a program for the continuous evaluation of all pesticides registered in the State.

Department of Health Services

Medical Assistance Program

The State Needs To Improve Its Preparation of Citations and Its Assessments of Penalties Against Nursing Homes (P-455, 11-8-84)

(1) Licensing and Certification Division administrators reduced or dismissed citations and penalties because evaluators did not gather enough evidence to support the citations and made technical errors in processing citations.

(2) The Licensing and Certification Division does not always correctly assess penalties against nursing homes that repeat a violation within a 12-month period.

See also reports P-441 and P-536 under Department of Mental Health.

A Review of Treatment Authorization Requests Before and After the Medi-Cal Reforms of 1982 (P-444, 10-18-84)

(1) Because of the Medi-Cal reforms of 1982, the total number of Treatment Authorization Requests (TARs) received by the Department of Health Services during 1983 declined significantly, but the number of TARs increased in 1984. In addition, the rate at which the department approved TARs decreased, and the rate at which the department returned TARs to providers increased. The rates at which the department modified or denied TARs did not change significantly.

A Review of Nursing Homes' Costs (P-455.1, 3-6-85)

(1) Nursing home operators do not always use a proportionate share of the Medi-Cal reimbursements to cover increased loan costs. Neither state laws nor regulations require nursing home operators to use a share of their Medi-Cal revenues for specific purposes.

(2) Nursing home operators spend Medi-Cal funds for products and services that are not related to providing patient care or that exceed "reasonable" costs as defined by Medi-Cal guidelines.

The Department of Health Services' Involvement in the Cleanup of Hazardous Waste Sites (P-565, 8-20-85)

(1) The Department of Health Services did not adequately document its involvement in the cleanup of 125 hazardous waste sites between March 1980 and April 1985.

(2) The department did not accurately report the quantities of hazardous waste cleaned up at 55 of the 125 sites.

Fire Departments' Compliance With Cal/OSHA Regulations for Protective Clothing and Equipment (P-416, 9-24-84)

(1) California fire departments generally provide their paid fire fighters with protective clothing and equipment required by the California Occupational Safety and Health Act. However, volunteer fire fighters who are not covered by the California Occupational Safety and Health Act do not always have sufficient quantities of protective clothing and equipment.

Hazardous Waste Programs

Occupational Safety & Health Act

Department of Industrial Relations

Agency Receiving Federal Funds

Department of Mental Health

Federal Grant

Alcohol and Drug Abuse and Mental Health Services Block Grant

Report Title and Description

The Department of Mental Health Has Deficient Accounting and Grant Management Practices (P-364, 9-5-84)

(1) The Department of Mental Health has not followed correct collection and accounting practices and has not properly managed a federal block grant.

(2) The department has withdrawn federal block grant funds from the U.S. Treasury long before it has disbursed such funds to the counties, has not maintained an accurate accounting of costs of administering the block grant, and has not audited recipients of block grant funds.

Medical Assistance Program

The State's Mental Health System Could Be Operated More Cost-Effectively and Could Better Meet the Needs of Clients (P-441, 3-14-85)

(1) Some mental health facilities have not promptly discharged clients to lower levels of care because of relative shortages of mental health resources below the acute care level, clients' reputations for being troublesome, and problems in arranging funding for treatment.

(2) Counties are not collecting all possible revenue for mental health services from clients, insurance firms and the federal government. In addition, the department is not adequately enforcing state requirements for collecting revenue.

(3) The Department of Health Services does not always enforce compliance with standards, and in some instances, does not have the mechanism to do so.

Review of Two Health Care Facilities in San Diego County (P-536, 6-26-85)

(1) The San Diego County Hillcrest Mental Health Facility may have been able to prevent the deaths of three clients. Also, the Department of Health Services identified numerous violations at Edgemoor Geriatric Hospital and the San Diego Hillcrest Mental Health Facility.

Agency Receiving Federal Funds

State Controller and Local Governments

Federal Grant

Federal Land Payments

Report Title and Description

State of California Statement of Federal Land Payments October 1, 1982 Through September 30, 1983 (F-467, 8-30-84)

(1) From October 1, 1982, through September 30, 1983, the State of California received \$55.6 million under federal payment laws. In accordance with state law, the State transferred \$12.5 million to eligible units of local government, transferred \$37.8 million to school districts or county school service funds, and retained or used for other purposes \$5.3 million.

State of California Statement of Federal Land Payments October 1, 1983 Through September 30, 1984 (F-552, 7-19-85)

(1) From October 1, 1983, through September 30, 1984, the State of California received \$100.5 million under federal payment laws. In accordance with state law, the State transferred \$26.4 million to eligible local governments, transferred \$67.8 million to school districts or county school service funds, and retained \$6.3 million.

Student Aid Commission

Higher Education Act Insured Loans (Guaranteed Student Loans)

California Student Aid Commission, State Guaranteed Loan Reserve Fund, Financial Audit Report, Year Ended June 30, 1984 (F-450, 11-9-84)

(1) During the year ended June 30, 1984, the federal government purchased \$86.9 million of the \$88.7 million of defaulted loans. The amount of \$88.7 million does not include \$6.1 million in defaulted loans that the federal government had not yet purchased at June 30, 1984.

Defaulted Loans Under the California Guaranteed Student Loan Program (P-380, 9-20-84)

(1) Since federal fiscal year 1981-82, the California Guaranteed Student Loan program's cumulative default rate has been increasing. This rise in defaulted loans increases the burden to federal taxpayers because the federal government purchases most of these defaulted loans.

Agency Receiving Federal Funds

Federal Grant

Report Title and Description

California Student Aid Commission, State Guaranteed Loan Reserve Fund, Years Ended June 30, 1984 and 1985 (F-556, 11-21-85)

(1) The amount of defaults by student loan borrowers during fiscal year 1984-85 increased 33 percent over fiscal year 1983-84. The fund balance for the Guaranteed Student Loan Program increased by \$13.1 million during the year, resulting in an ending balance of \$85.4 million at June 30, 1985.

Department of Transportation

Highway Funds

Review of the Department of Transportation's Contract of the I-580 Interchange in Castro Valley (P-523, 7-15-85)

(1) Caltrans should decertify one of the subcontractors certified as a Woman Business Enterprise and the contractor should make a "good faith" effort to replace the firm with a certified Woman Business Enterprise.

Various State Agencies That Administer Federal Programs

Various Federal Programs

The State's General Fund Has Not Recovered Over \$2 Million in Costs Incurred To Administer Federal Programs (F-406, 10-16-84)

(1) State agencies are not collecting and remitting federal reimbursements for the State's cost of administering federal programs.

(2) The Department of Finance has not transferred statewide cost allocation plan (SWCAP) reimbursements to the General Fund when agencies fail to make such transfers, nor has the department followed up on agencies that do not supply or comply with indirect cost rate proposals.

(3) The department's ability to monitor the collection of SWCAP reimbursements is limited because it no longer requires agencies to report these collections in their financial statements at the end of the year.

DEPARTMENT OF FINANCE

SACRAMENTO, CA 95814-4998



March 7, 1986

Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Hayes:

**REPORT F-580--THE STATE OF CALIFORNIA MUST PLACE GREATER EMPHASIS ON IMPROVING
THE CONTROL OF ITS FINANCIAL OPERATIONS--FEBRUARY 1986**

I appreciate the opportunity to respond to the draft copy of the subject report which was prepared in connection with your examination of the State's general purpose financial statements for the fiscal year ended June 30, 1985. The draft includes your report on the study and evaluation of internal controls and your report on compliance with federal grant requirements and together with your summary of audit results. We all agree that the control of the State's financial operations is important and we feel steps have been taken to adopt various improvements. These improvements include the installation of CALSTARS in a number of new State agencies, the adoption of Generally Accepted Accounting Principles (GAAP) as it relates to the proper identification of revenues and reimbursements, and the further use of EDP procedures in the budget process. While more changes are planned, we are moving with due care to avoid any disruptions of procedures.

REPORT ON THE STUDY AND EVALUATION OF INTERNAL CONTROL

The report on the study and evaluation of internal control disclaims an opinion on the State's system of internal accounting controls due to the limited nature of your examination. The report discloses only one weakness in accounting for general fixed assets that could have a material effect on the State's general purpose financial statements. The weakness regarding the accounting for fixed assets was reported previously. While we acknowledge it exists, we must consider the cost/benefits associated with resolving this issue on a statewide basis and to date we feel there are higher priorities. It also discloses certain other conditions requiring the attention of management. These conditions do not have a material effect on the State's general purpose financial statements.

When considering the total State spending plan for the 1984-85 fiscal year of \$53.2 billion as shown in Schedule 2 of the Governor's Budget for the 1986-87 fiscal year, I am most pleased that the State has an effective system of internal control in place and operative, albeit some improvements should be made. The system of internal control is under continuous review by our Financial and Performance Accountability (FPA) Unit, which examines and issues opinion reports on the system in the various State agencies on a two-year cyclical basis. Whenever necessary, these reports present findings and recommendations to improve internal controls, including accounting for general fixed assets. In addition, the FPA Unit performs quality control reviews on internal control examinations, required by Section 20010 of the State Administrative Manual, made by State agency internal auditors.

REPORT ON COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS

The report on compliance with federal grant requirements gives a qualified opinion, due to your scope limitations, that the State complied with the terms and conditions of its grant awards and applicable federal regulations in all material respects for transactions tested (positive assurance) and for transactions not tested (negative assurance). It also discloses some instances of noncompliance requiring the attention of management. We understand these instances of noncompliance are not material in relation to the grant awards.

The report also gives an unqualified opinion on the schedule of federal assistance for the fiscal year ended June 30, 1985. That is, it is fairly stated in all material respects in relation to the State's general purpose financial statements.

When considering the total State spending plan for the 1984-85 fiscal year, which includes \$13.3 billion of federal funds as shown in Schedule 2 of the Governor's Budget for the 1986-87 fiscal year, I am most pleased that the State has complied in all material respects with the many federal requirements, albeit some improvements can be made.

SUMMARY OF AUDIT RESULTS

Your summary of audit results classifies those matters requiring the attention of management which do not have a material effect on the State's general purpose financial statements and federal grant awards, as applicable to financial operations, electronic data processing activities, internal audit standards, compliance with State regulations, and compliance with federal regulations.

Your 21 management letters, applicable to the 32 detailed reviews made within the total of 294 State agencies, have been received by those State agencies. They have either replied or are in the process of replying to the management letters. These letters are being monitored by the FPA Unit and replies will be received from all the affected agencies. A follow-up report regarding corrective actions will be made as a part of the continuous review made by FPA of internal controls and fiscal procedures in various State agencies.

Financial Operations

I am also concerned regarding the timeliness of State agency financial reports. I have directed both the Fiscal Systems and Consulting Unit and CALSTARS Unit to stress the need for timely submission of financial reports during their annual year-end closing training sessions for State agency accounting personnel.

Relative to the State's implementation of Generally Accepted Accounting Principles (GAAP), the Governor's Budget for the 1986-87 fiscal year highlights the major effort which is currently in progress (refer to page 4). Specific matters being considered are identified in Schedule 2 of the Governor's Budget.

Electronic Data Processing Activities

In the area of electronic data processing activities, a May 1985 report, "Computer Information Security in California State Government," by a national public accounting firm addressed the vulnerability of the State's computer information assets to improper disclosure, modification, or destruction. As a result of this report, our Office of Information Technology is preparing an Information Technology Security Manual which will provide policies and guidelines for electronic data processing activities. This manual will replace those security and control provisions currently in the State Administrative Manual.

The State also has a contract with another public accounting firm to develop a statewide strategy and operational plan for disaster recovery for our large data centers and departments with significant computer information assets.

Internal Audit Standards

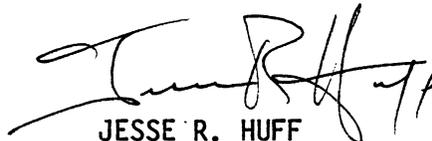
As previously mentioned, the FPA Unit performs quality control reviews on internal control examinations made by state agency internal auditors. Their reviews are designed to insure that State agency internal auditors are complying with the audit guide developed by FPA and the applicable "Standards for the Professional Practice of Internal Auditing" required by Section 1236 of the Government Code. Findings and recommendations to improve State agency internal audit efforts are included in the quality control reports.

Compliance with State and Federal Regulations

The review of compliance with State regulations concentrated upon 14 controls which were identified in your report. The review of compliance with federal regulations identified seven State agencies where controls needed improvement. Since the need for these improvements in controls was addressed in your management letters to the State agencies, their replies will include corrective actions taken or to be taken.

In closing, we appreciate your efforts in reviewing and reporting upon the financial operations of our State. Where weaknesses have been reported, we will make every effort to seek and effect corrective action. We will continue to make improvements to our financial system and procedures since we all wish to provide to the citizens of California the best services possible.

Very truly yours.



JESSE R. HUFF
Director of Finance

cc: Curt I. Davis, CPA, Deputy Auditor General
Office of the Auditor General

PART II

**STATE OF CALIFORNIA
FINANCIAL REPORT
YEAR ENDED JUNE 30, 1985**

TABLE OF CONTENTS

	<u>Page</u>
<u>INTRODUCTORY SECTION</u>	
STATE CONTROLLER'S LETTER	3
STATE CONTROLLER'S OVERVIEW	5
OFFICIALS OF THE STATE OF CALIFORNIA	9
THE EXECUTIVE BRANCH OF THE STATE OF CALIFORNIA	10
<u>FINANCIAL SECTION</u>	
AUDITOR'S REPORT	13
GENERAL PURPOSE FINANCIAL STATEMENTS	
COMBINED BALANCE SHEET	16
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES	19
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES -- BUDGET AND ACTUAL (LEGAL BASIS)	21
COMBINED STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN RETAINED EARNINGS/FUND BALANCES	23
COMBINED STATEMENT OF CHANGES IN FINANCIAL POSITION	25
COMBINED BALANCE SHEET ALL UNIVERSITY OF CALIFORNIA FUNDS	27
COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES ALL UNIVERSITY OF CALIFORNIA CURRENT FUNDS	29
COMBINED STATEMENT OF CHANGES IN FUND BALANCES UNIVERSITY OF CALIFORNIA FUNDS	31
NOTES TO THE FINANCIAL STATEMENTS	33

TABLE OF CONTENTS (Continued)

	<u>Page</u>
<u>STATISTICAL SECTION</u>	
SELECTED TAX REVENUE (LEGAL BASIS) BY SOURCE COMPARATIVE YIELD OF STATE TAXES FISCAL YEARS 1976-1985	65
RATIO OF GENERAL LONG-TERM BONDED DEBT TO PER CAPITA INCOME FISCAL YEARS 1978-1985	66
COMPARISON OF NATIONAL TO STATE POPULATION CALENDAR YEARS 1940-1984	67
COMPARISON OF NATIONAL TO STATE PERSONAL INCOME CALENDAR YEARS 1970-1984	68
COMPARISON OF NATIONAL TO STATE PER CAPITA PERSONAL INCOME CALENDAR YEARS 1970-1984	69
CIVILIAN LABOR FORCE FOR RESIDENT POPULATION AGE 16 AND OVER CALENDAR YEARS 1973-1984	70
PERSONS EMPLOYED IN PRINCIPAL MANUFACTURING INDUSTRIES CALENDAR YEARS 1982 AND 1984 .	71

INTRODUCTORY SECTION



KENNETH CORY

Controller of the State of California

SACRAMENTO, CALIFORNIA 95805

March 21, 1986

People of the State of California
Honorable George Deukmejian,
Governor
Honorable David Roberti,
Senate President pro Tempore
Honorable Willie L. Brown, Jr.,
Speaker of the Assembly

Attached are the General Purpose Financial Statements of the State of California prepared in accordance with generally accepted accounting principles (GAAP). This report meets the disclosure standards of the accounting profession and is primarily intended to meet the needs of users outside of state government. My Annual Report, prepared on a legal/budgetary basis which is in compliance with existing state laws and state accounting principles, should continue to be used as a focal point for past executions of the State's budget as well as for future budget planning.

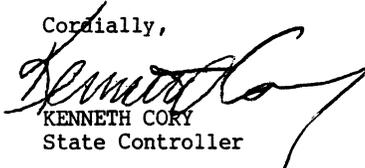
On a legal/budgetary basis, the General Fund, the main operating fund of the State, ended the 1984-85 fiscal year with an undesignated reserve (surplus) of \$1,337,091,578. Pursuant to Section 12.30(e) of the 1984 Budget Act, the Contingency Reserve for Economic Uncertainties was increased to this amount.

The June 30, 1985 reserve is \$1,009,442,146 larger than the reserve of the previous year. If the reserve is allowed to increase in the future, the State of California will be prepared to withstand a sudden decline in the economy. However, estimates prepared by the Department of Finance indicate the portion of the fund balance set aside for economic uncertainties as decreasing from the June 30, 1985 amount. A more prudent policy would allow the reserve to increase during the periods of economic expansion so that funds would be available when they are needed.

A reconciliation between the legal/budgetary fund balance to the GAAP basis fund balance of the General Fund is presented in Note 3 of this report.

My staff and I wish to express our appreciation to all state agencies for their assistance and to the Auditor General's staff for their audit of the financial statements contained in this report.

Cordially,


KENNETH CORY
State Controller

STATE CONTROLLER'S OVERVIEW

This report presents the General Purpose Financial Statements of the State of California in conformance with generally accepted accounting principles (GAAP). In addition, the State Controller's office is also required by law to publish the State of California Annual Report (the "legal basis financial report"). The legal basis financial report is prepared in accordance with legal and regulatory requirements and is used for reporting on the execution of the State's budget as well as for future budget planning. The accounting records of state agencies are maintained on the legal basis for the primary purpose of maintaining accountability of the State's budget and fiscal legislation; they are the records used as the basis for audit. After the legal basis report is prepared, adjustments are made to prepare the GAAP basis report.

A reconciliation of the two accounting bases for the General Fund, along with an explanation of the primary differences, is provided on pages 38 through 41 of this report. A reconciliation showing the differences between the two accounting bases for the Special Revenue fund balances is provided on page 42 of this report.

The Auditor General is required by statute to issue an auditor's report annually, on the State's General Purpose Financial Statements (GAAP basis report). The auditor's report did not disclose any material errors in either the legal basis or the GAAP basis financial statements. The report of the Auditor General is included in the financial section of this report.

Current General Obligation Bond Rating and Debt Position

The State's current general obligation bond ratings are as follows:

- Moody's Aa
- Standard & Poor's AA+

The general obligation debt position of the State at June 30, 1985, is provided in Note 10, pages 47 through 49 of the financial section. In accordance with the Constitution, this debt was approved by two-thirds of both houses of the Legislature and by a majority of the electorate voting in a general election or a direct primary.

General Fund Condition

The State ended the 1984-85 fiscal year with a General Fund Undesignated Reserve (surplus) of \$1.3 billion according to the legal basis of accounting. Pursuant to Section 12.30(e) of the 1984 Budget

Act, the Contingency Reserve for Economic Uncertainties was increased up to this amount. The Contingency Reserve is to be expended only upon reappropriation by the Legislature. There was a Fund Balance - Designated for Economic Uncertainties of \$611.2 million according to the GAAP basis of accounting. The General Fund legal basis and GAAP basis fund balances are reconciled on page 40 of this report.

Article XIIIIB of the State Constitution

The State is subject to an annual "appropriations limit" imposed by Article XIIIIB of the State Constitution. This article establishes a limit on the growth of certain appropriations, made from tax revenues, adjusted for changes in the Consumer Price Index and population. No limit is imposed on appropriations or funds which are not "proceeds of taxes," such as reasonable user charges or fees, and certain other nontax funds. For fiscal year 1984-85 the State is in compliance with the appropriations limit established in Control Section 12.0 of the Budget Act as required by Article XIIIIB. Based on the 1986-87 Governor's Budget, "appropriations subject to limitation" are:

STATE APPROPRIATIONS LIMIT
(IN MILLIONS)

	<u>1978-79</u> <u>Base</u>	<u>1984-85</u> <u>Limit</u>	<u>1985-86</u> <u>Limit</u>
State appropriations limit	\$12,564	\$21,740	\$23,030
Appropriations subject to limitation		<u>(20,822)</u>	<u>(22,154)</u>
Amount under limit		<u>\$ 918</u>	<u>\$ 876</u>

Cash Management

The State borrowed during the 1984-85 fiscal year to meet the cash needs of July, August, and October. To meet these needs, \$1.4 billion in revenue anticipation notes were issued. All notes matured prior to the end of June 1985 and were paid from available monies in the General Fund of the State.

For fiscal year 1985-86, \$2.3 billion in revenue anticipation notes were issued in August to meet the cash flow needs of the General Fund. All notes will mature prior to the end of June 1986 and will be payable from available monies in the General Fund of the State, including, if necessary, amounts that may be borrowed from the special funds of the State.

Economic Outlook

California's economy has slowed significantly from the exceptionally rapid expansion during 1984. However, state economists still foresee moderate growth for the State through 1986. The slowdown in the national economy is having only a slight effect on the State of California because California's economy is expected to outperform the nation.

**OFFICIALS OF THE
STATE OF CALIFORNIA**

EXECUTIVE

George Deukmejian
Governor

Leo T. McCarthy
Lieutenant Governor

Kenneth Cory
State Controller

John Van de Kamp
Attorney General

Jesse M. Unruh
State Treasurer

March Fong Eu
Secretary of State

Bill Honig
Superintendent of Public Instruction

LEGISLATIVE

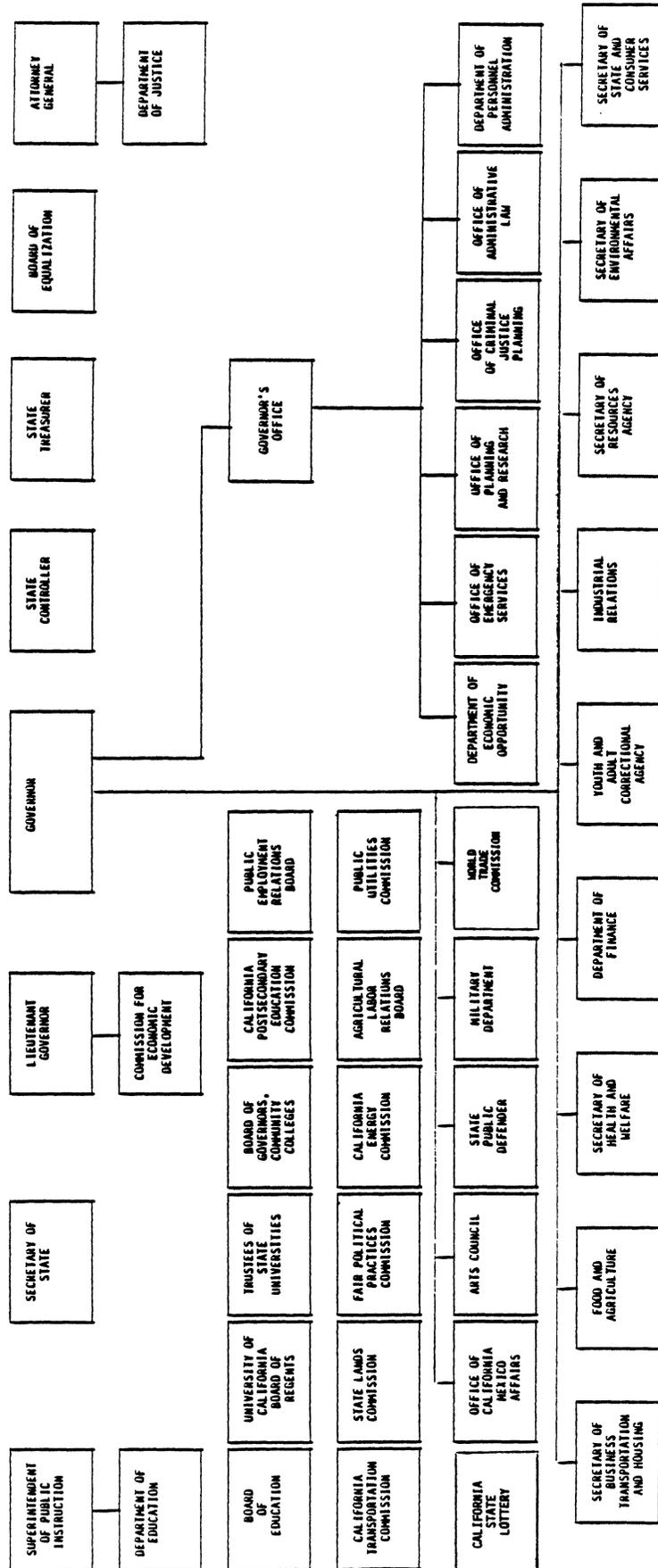
David Roberti
President pro Tempore, Senate

Willie L. Brown, Jr.
Speaker of the Assembly

JUDICIAL

Rose Bird
Chief Justice, State Supreme Court

**THE EXECUTIVE BRANCH
OF THE
STATE OF CALIFORNIA**



FINANCIAL SECTION



Telephone:
(916) 445-0255

STATE OF CALIFORNIA
Office of the Auditor General

660 J STREET, SUITE 300
SACRAMENTO, CA 95814

Thomas W. Hayes
Auditor General

Members of the Joint Legislative Audit Committee
State of California

We have examined the General Purpose Financial Statements of the State of California as of and for the year ended June 30, 1985, as listed in the table of contents. Except as explained in the following two paragraphs, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of the Pension Trust Funds which reflect total assets constituting 67 percent of the Fiduciary Funds. We also did not examine the financial statements of certain Enterprise Funds, which reflect total assets and revenues constituting 60 percent and 68 percent, respectively, of the Enterprise Funds. In addition, we did not examine the University of California Funds. Except for the financial statements of the State Teachers' Retirement System, as explained in the following paragraph, the financial statements of the Pension Trust Funds, certain Enterprise Funds, and the University of California Funds referred to above were examined by other auditors who furnished their reports to us. Thus, our opinion, insofar as it relates to the audited amounts included in the Pension Trust Funds, certain Enterprise Funds, and the University of California Funds, is based solely upon the reports of other independent auditors.

The General Purpose Financial Statements referred to above include the financial activities of the State Teachers' Retirement System which represents 24 percent of the assets of the Fiduciary Fund Type and 37 percent of the revenues of the Pension Trust Funds. We did not audit the State Teachers' Retirement System and we were unable to obtain audited financial statements because the audit of that fund by other independent auditors was not completed by the date our report was issued.

The State has not maintained adequate fixed asset records for its governmental fund type property, plant, and equipment. Consequently, the General Fixed Assets Account Group is not presented in the accompanying financial statements prepared according to generally accepted accounting principles.

In our opinion, based upon our examination and the reports of the other independent auditors, except for the effects of any adjustments, if any, that we might have determined to be necessary had we audited the financial statements of the State Teachers' Retirement System or if audited financial statements of that fund had been furnished to us, and except for the effect of the omission of the General Fixed Assets Account Group, the General Purpose Financial Statements referred to in the first paragraph present fairly the financial position of the State of California as of June 30, 1985, and the results of its operations and the changes in financial position of its Proprietary Funds and Pension Trust Funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

We have not audited the other data included in this report, and accordingly, we express no opinion on that data.

OFFICE OF THE AUDITOR GENERAL


CURT DAVIS, CPA
Deputy Auditor General

December 20, 1985

GENERAL PURPOSE FINANCIAL STATEMENTS

STATE OF CALIFORNIA
COMBINED BALANCE SHEET -- ALL FUND TYPES AND ACCOUNT GROUP
AS OF JUNE 30, 1985
(IN THOUSANDS)

	Governmental Fund Types			Proprietary Fund Types		Fiduciary Fund Type		Account Group
	General	Special Revenue	Capital Projects	Enterprise	Internal Service	Trust and Agency	General Long-term Obligations	University of California
Cash and pooled investments	\$1,203,597	\$ 800,026	\$677,457	\$ 179,936	\$ 42,171	\$12,198,657		\$ 1,061,911
Investments				2,569,939		39,299,659		6,127,410
Amount on deposit with U.S. Treasury								
Receivables (net)	82,082	49,714	441	238,786	11,047	3,383,836		588,029
Due from other funds	1,152,352	2,201,126	16,336	2,066,964	74,826	2,061,207		72,704
Due from other governments	12,602	1,448,757		143,966	1,298	5,569,417		122,968
Prepaid expenses	231,899	78,641	7	42,025	6,673	73,224		
Inventory, at cost				10,827	34,959	106,529		
Other assets	293	2,543	174	20,015	40	126,219		120,108
Advances and loans receivable	402,967	438,070		5,666,679	2,882	215,014		38,115
Deferred charges				840,079				
Fixed assets				3,718,577	103,351	801		4,516,360
Amounts to be provided for retirement of long-term obligations							\$3,869,883	
Total Assets	\$3,085,792	\$5,018,877	\$694,415	\$15,497,793	\$277,247	\$63,034,563	\$3,869,883	\$12,647,605

LIABILITIES AND FUND EQUITY	
Liabilities	
Accounts payable	\$ 371,910
Agreements to repurchase securities	\$ 291,168
Due to other funds	\$ 42,539
Due to other governments	\$ 93,430
Dividends payable	\$ 62,295
Advances from other funds	\$ 18,433
	\$ 173
	\$ 31,619
	\$ 412,706
	\$ 72,704
	\$ 38,115

Tax overpayments	83,006					40,325		
Benefits payable						238,306		
Deposits	90					792,255		11,342
Notes payable							1,679	
Compensated absences payable	67,629						\$ 336,154	
Mortgages and other borrowings								360,866
Net assets available for University of California retirement benefits								5,904,089
Capital lease obligations								111,545
Advance collections	122,356	77,781	67			12,969	114,737	
General obligation bonds payable								202,380
Revenue bonds payable	47,621							
Interest payable	16,434	21,898	450					
Other liabilities							1,056	
Total Liabilities	<u>1,731,452</u>	<u>2,725,259</u>	<u>57,705</u>			<u>16,919,620</u>	<u>3,869,883</u>	<u>7,113,747</u>
Fund Equity								
Contributed capital								
Investment in general fixed assets								
Retained earnings								4,048,681
Reserved for regulatory requirements								
Unreserved								
Fund balances								
Reserved for encumbrances	277,076	750,746	108,103					
Reserved for advances and loans	402,967	438,070				190,447		
Reserved for employees' retirement system								41,725,144
Reserved for other specific purposes								710,973
Unreserved								
Designated for subsequent years' expenditures								
Designated for University of California	63,119	45,531	238,133					
Designated for economic uncertainties								
Undesignated	611,178							774,204
Total Fund Equity	<u>1,354,340</u>	<u>2,293,618</u>	<u>636,710</u>			<u>4,199,352</u>	<u>46,114,943</u>	<u>5,533,858</u>
Total Liabilities and Fund Equity	<u>\$3,085,792</u>	<u>\$5,018,877</u>	<u>\$694,415</u>			<u>\$63,034,563</u>	<u>\$3,869,883</u>	<u>\$12,647,605</u>

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
 COMBINED STATEMENT OF REVENUES, EXPENDITURES,
 AND CHANGES IN FUND BALANCES
 ALL GOVERNMENTAL FUND TYPES AND EXPENDABLE TRUST FUNDS
 FOR THE FISCAL YEAR ENDED JUNE 30, 1985
 (IN THOUSANDS)

	<u>Governmental Fund Types</u>			<u>Fiduciary Fund Type</u>
	<u>General</u>	<u>Special Revenue</u>	<u>Capital Projects</u>	<u>Expendable Trust</u>
Revenues				
Taxes	\$25,463,084	\$ 811,628		\$3,199,816
Intergovernmental	66,698	8,869,172		39,289
Licenses and permits	129,379	1,094,678		
Natural resources	22,110	169,756	\$324,151	277
Charges for services	44,425	157,967		101,106
Fees	264,146	157,957		
Penalties	13,218	66,350		
Interest	476,712	149,893	332	360,153
Miscellaneous	47,033	102,532		180,363
Total Revenues	<u>26,526,805</u>	<u>11,579,933</u>	<u>324,483</u>	<u>3,881,004</u>
Expenditures				
Current				
General government	1,103,553	614,594		67,449
Education	13,810,903	1,180,307		36,440
Health and welfare	7,842,942	6,311,058		2,996,145
Resources	380,032	219,584		38,368
State and consumer services	180,702	437,333		70,212
Business and transportation	56,005	2,856,829		2,233
Correctional programs	1,035,130	176,688		
Property tax relief	944,850			
Capital outlay	9,155		285,450	
Debt service				
Principal retirement	203,258			
Interest and fiscal charges	172,571			
Total Expenditures	<u>25,739,101</u>	<u>11,796,393</u>	<u>285,450</u>	<u>3,210,847</u>
Other Financing Sources (Uses)				
Proceeds from general obligation bonds		250,000	380,000	110,000
Operating transfers in	34,135	414,427	81,863	25,798
Operating transfer out	(141,957)	(205,840)	(28,298)	(1,709)
Total Other Financing Sources (Uses)	<u>(107,822)</u>	<u>458,587</u>	<u>433,565</u>	<u>134,089</u>
Excess of Revenues and Other Sources Over Expenditures and Other Uses	<u>679,882</u>	<u>242,127</u>	<u>472,598</u>	<u>804,246</u>
Fund Balances, July 1, 1984	<u>674,458</u>	<u>2,051,491</u>	<u>164,112</u>	<u>3,585,553</u>
Fund Balances, June 30, 1985	<u>\$ 1,354,340</u>	<u>\$ 2,293,618</u>	<u>\$636,710</u>	<u>\$4,389,799</u>

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
 COMBINED STATEMENT OF REVENUES, EXPENDITURES, AND
 CHANGES IN FUND BALANCES -- BUDGET AND ACTUAL (LEGAL BASIS)
 GENERAL AND SPECIAL REVENUE FUND TYPES
 FOR THE FISCAL YEAR ENDED JUNE 30, 1985
 (IN THOUSANDS)

	General Fund			Special Revenue Funds		
	Budget	Actual	Variance- Favorable (Unfavorable)	Budget	Actual	Variance- Favorable (Unfavorable)
Revenues						
Taxes		\$25,514,709			\$ 98,719	
Intergovernmental		30,812			8,903,474	
Licenses and permits		11,935			1,100,156	
Natural resources		22,110			178,884	
Charges for services		44,425			151,167	
Fees		61,648			157,957	
Penalties		12,102			78,715	
Interest		476,995			145,103	
Miscellaneous		377,665			365,874	
Total Revenues		<u>26,552,401</u>			<u>11,180,049</u>	
Expenditures						
Current						
General government	\$ 1,119,861	1,039,387	\$ 80,474	\$ 767,564	699,338	\$ 68,226
Education	13,794,473	13,538,829	255,644	1,289,481	1,174,064	115,417
Health and welfare	8,172,408	8,008,707	163,701	5,674,070	5,648,038	26,032
Resources	391,642	387,913	3,729	296,689	258,603	38,086
State and consumer						
services	185,676	182,353	3,323	497,281	473,795	23,486
Business and						
transportation	63,866	62,576	1,290	3,076,898	2,899,503	177,395
Correctional programs	1,054,385	1,046,215	8,170	254,386	176,683	77,703
Property tax relief	948,402	946,929	1,473			
Capital outlay	9,251	9,155	96			
Debt service						
Principal retirement	201,370	201,370				
Interest and fiscal						
charges	175,327	174,327	1,000			
Total Expenditures	<u>\$26,116,661</u>	<u>25,597,761</u>	<u>\$518,900</u>	<u>\$11,856,369</u>	<u>11,330,024</u>	<u>\$ 526,345</u>
Other Financing Sources						
(Uses)						
Operating transfers in		74,142			3,271,941	
Operating transfers out		(159,325)			(2,863,786)	
Total Other Financing Sources (Uses)		<u>(85,183)</u>			<u>408,155</u>	
Excess of Revenues and Other Sources Over Expenditures and Other Uses		869,457			258,180	
Fund Balances, July 1, 1984, as restated		<u>530,754</u>			<u>833,489</u>	
Fund Balances, June 30, 1985		<u>\$ 1,400,211</u>			<u>\$ 1,091,669</u>	

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
 COMBINED STATEMENT OF REVENUES, EXPENSES, AND
 CHANGES IN RETAINED EARNINGS/FUND BALANCES
 ALL PROPRIETARY FUND TYPES AND PENSION TRUST FUNDS
 FOR THE FISCAL YEAR ENDED JUNE 30, 1985
 (IN THOUSANDS)

	<u>Proprietary Fund Types</u>		<u>Fiduciary Fund Type</u>
	<u>Enterprise</u>	<u>Internal Service</u>	<u>Pension Trust</u>
Operating Revenues			
Services and sales	\$ 644,688	\$523,060	
Earned premiums, net	601,114		
Investment and interest	721,595		\$ 4,161,788
Contributions			3,925,995
Miscellaneous	<u>5,640</u>	<u>354</u>	<u>3,223</u>
Total Operating Revenues	<u>1,973,037</u>	<u>523,414</u>	<u>8,091,006</u>
Operating Expenses			
Personal services	120,738	251,920	28,617
Supplies	6,742	15,877	
Services and charges	365,070	243,970	19,688
Depreciation	52,796	11,420	
Benefit payments	498,518		2,375,230
Interest expense	408,523		
Refunds			214,155
Amortization of deferred charges	<u>15,187</u>		
Total Operating Expenses	<u>1,467,574</u>	<u>523,187</u>	<u>2,637,690</u>
Operating Income	<u>505,463</u>	<u>227</u>	<u>5,453,316</u>
Nonoperating Revenues (Expenses)			
Grants received	1,667		
Grants provided	(19,836)		
Interest revenue	212,035		
Rent	6,953		
Interest expense and fiscal charges	(150,500)	(100)	
Loss on early extinguishment of debt	<u>(49,602)</u>		
Total Nonoperating Revenues (Expenses)	<u>717</u>	<u>(100)</u>	
Operating transfers in	16,873	12,035	
Operating transfers out	<u>(10,098)</u>	<u>(7,790)</u>	
Operating Transfers	<u>6,775</u>	<u>4,245</u>	
Net Income	512,955	4,372	5,453,316
Dividends paid	(220,268)		
Retained Earnings/Fund Balances			
July 1, 1984	<u>2,993,928</u>	<u>145,510</u>	<u>36,271,828</u>
Retained Earnings/Fund Balances			
June 30, 1985	<u>\$3,286,615</u>	<u>\$149,882</u>	<u>\$41,725,144</u>

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
COMBINED STATEMENT OF CHANGES IN FINANCIAL POSITION
ALL PROPRIETARY FUND TYPES AND PENSION TRUST FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 1985
(IN THOUSANDS)

	<u>Proprietary Fund Types</u>		<u>Fiduciary</u> <u>Fund Type</u>
	<u>Enterprise</u>	<u>Internal</u> <u>Service</u>	<u>Pension</u> <u>Trust</u>
Sources of Funds			
From operations			
Net income	\$ 512,955	\$ 4,372	\$ 5,453,316
Add (deduct) items not affecting cash			
Depreciation	52,796	11,420	
Amortization of bond and note discount and premium	(516)		(215,074)
Loss on early extinguishment of debt	49,602		
Accrual of deferred expenses	67,209		
Imputed interest earnings	(44,517)		
Funds Provided from Operations	637,529	15,792	5,238,242
Proceeds from investments	89,093		19,344,340
Collection of loans receivable	154,417		
Proceeds from sale of fixed assets	381	696	27
Advances from other funds	42,973		
Proceeds from bonds and notes	1,718,827		
Decreases in current assets			
Receivables	112,491	3,717	
Due from other funds	13,258	13,288	
Due from other governments	673	164	
Prepaid expenses	27	2,750	
Inventory	4,272	777	
Other assets	40,687	51	
Increases in current liabilities			
Accounts payable	25,256	14,302	
Due to other funds	20,642	3,855	110
Due to other governments	9		
Dividends payable	27,000		
Benefits payable	139,159		26,627
Deposits	1,018		
Compensated absences payable	17	1,679	
Advance collections	61,258	9,489	
Interest payable	53,243		
Other liabilities	5,230	4	58,168
Total Funds Provided	3,147,460	66,564	24,667,514
Application of Funds			
Purchase of investments	611,114		23,717,063
Advances to other funds	16,878	1,490	
Loans provided	543,248		
Acquisition of fixed assets	206,640	27,094	
Payments on advances from other funds	94,009	4,100	
Dividends paid	220,268		
Payments on notes	116,498		
Retirement of bonds	603,139		
Unamortized water project costs	6,963		
Increases in current assets			
Receivables	56,954	1,136	161,233
Due from other funds	455,645	7,614	697,378
Due from other governments	112,055	477	
Prepaid expenses	11,230	4,942	202
Inventory	50	58	
Other assets	4,757		91,618
Decreases in current liabilities			
Accounts payable	90,095	1,939	
Due to other funds	11,002	20,096	
Due to other governments	11,367	680	
Deposits	484		
Advance collections	21	503	
Interest payable	1,413		
Other liabilities	5,384	1,144	
Total Funds Applied	3,179,214	71,273	24,667,494
Net Increase (Decrease) in Cash	\$ (31,754)	\$ (4,709)	\$ 20

See the notes accompanying the financial statements.

**STATE OF CALIFORNIA
COMBINED BALANCE SHEET
ALL UNIVERSITY OF CALIFORNIA FUNDS
AS OF JUNE 30, 1985
(IN THOUSANDS)**

	<u>Current Funds</u>	<u>Loan Funds</u>	<u>Endowment & Similar Funds</u>	<u>Plant Funds</u>	<u>Retirement System Funds</u>	<u>Total</u>
ASSETS						
Cash and pooled investments	\$ 601,765	\$ 22,012	\$ 1,711	\$ 293,007	\$ 143,416	\$ 1,061,911
Investments			472,994		5,654,416	6,127,410
Receivables (net)	350,799	196,091	742		40,397	588,029
Due from other funds					72,704	72,704
Due from other governments	122,968					122,968
Other assets	116,829			3,279		120,108
Advances and loans receivable	343		37,772			38,115
Fixed assets				4,516,360		4,516,360
Total Assets	<u>\$1,192,704</u>	<u>\$218,103</u>	<u>\$513,219</u>	<u>\$4,812,646</u>	<u>\$5,910,933</u>	<u>\$12,647,605</u>
LIABILITIES AND FUND EQUITY						
Liabilities						
Accounts payable	\$ 387,832		\$ 585	\$ 17,445	\$ 6,844	\$ 412,706
Due to other funds	72,704					72,704
Advances from other funds		\$ 2,000		36,115		38,115
Deposits			11,342			11,342
Mortgages and other borrowings	75,000			285,866		360,866
Net assets available for University of California retirement benefits					5,904,089	5,904,089
Advance collections	102,737		8,808			111,545
Revenue bonds payable		22,735		179,645		202,380
Total Liabilities	<u>638,273</u>	<u>24,735</u>	<u>20,735</u>	<u>519,071</u>	<u>5,910,933</u>	<u>7,113,747</u>
Fund Equity						
Investment in general fixed assets				4,048,681		4,048,681
Fund balances						
Reserved for other specific purposes	198,847	147,395	305,120	59,611		710,973
Unreserved						
Designated for University of California	355,584	45,973	187,364	185,283		774,204
Total Fund Equity	<u>554,431</u>	<u>193,368</u>	<u>492,484</u>	<u>4,293,575</u>		<u>5,533,858</u>
Total Liabilities and Fund Equity	<u>\$1,192,704</u>	<u>\$218,103</u>	<u>\$513,219</u>	<u>\$4,812,646</u>	<u>\$5,910,933</u>	<u>\$12,647,605</u>

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
 COMBINED STATEMENT OF REVENUES,
 EXPENDITURES, AND CHANGES IN FUND BALANCES
 ALL UNIVERSITY OF CALIFORNIA CURRENT FUNDS
 FOR THE FISCAL YEAR ENDED JUNE 30, 1985
 (IN THOUSANDS)

Revenues	
Tuition and fees	\$ 311,940
Federal appropriations, grants, and contracts	634,622
State appropriations, grants, and contracts	1,494,211
Private gifts, grants, and contracts	167,983
Sales and services	
Educational activities	242,434
Auxiliary enterprises	232,723
Teaching hospitals	704,249
Local government	27,732
Major Department of Energy laboratories	1,768,647
Other	<u>172,160</u>
Total Revenues	<u>5,756,701</u>
Expenditures	
Instruction	987,237
Research	696,224
Public services	97,909
Academic support	373,922
Teaching hospitals	721,071
Student services	142,848
Institutional support	233,477
Operation and maintenance of plant	184,189
Student financial aid	132,934
Auxiliary enterprises	199,257
Major Department of Energy laboratories	1,761,972
Other	<u>14,143</u>
Total Expenditures	<u>5,545,183</u>
Other Financing Sources (Uses)	
Transfers out	<u>(144,874)</u>
Total Other Financing Sources (Uses)	<u>(144,874)</u>
Excess of Revenues and Other Sources Over Expenditures and Other Uses	66,644
Fund Balances, July 1, 1984	<u>487,787</u>
Fund Balances, June 30, 1985	<u>\$ 554,431</u>

See the notes accompanying the financial statements.

STATE OF CALIFORNIA
COMBINED STATEMENT OF CHANGES IN FUND BALANCES
UNIVERSITY OF CALIFORNIA FUNDS
FOR THE FISCAL YEAR ENDED JUNE 30, 1985
(IN THOUSANDS)

	<u>Current Funds</u>	<u>Loan Funds</u>	<u>Endowment & Similar Funds</u>	<u>Plant Funds</u>
Revenues and Other Additions				
Unrestricted current fund revenues				
General	\$2,137,418			
Auxiliary enterprises and hospitals	936,972			
Restricted gifts, grants, and contracts	2,510,151	\$ 448	\$ 14,695	\$ 26,364
Investment and interest income	86,004	2,150	1,992	18,995
Net gain (loss) on sale of investments	2,456		17,833	(169)
Governmental grants and contracts		3,332		1,248
Debt service fees				3,946
Governmental appropriations				15,698
Expended for plant facilities (including \$264,638 financed from current funds)				341,699
Retirement of indebtedness				29,452
Other	<u>83,700</u>	<u>21,882</u>	<u>347</u>	<u>7,474</u>
Total Revenues and Other Additions	<u>5,756,701</u>	<u>27,812</u>	<u>34,867</u>	<u>444,707</u>
Expenditures and Other Deductions				
Current fund expenditures	5,531,040			
Plant fund expenditures				85,699
Debt service				29,452
Principal retirement				27,550
Interest				42,746
Disposals of plant assets				10,130
Other	<u>14,143</u>	<u>4,996</u>	<u>2,199</u>	
Total Expenditures and Other Deductions	<u>5,545,183</u>	<u>4,996</u>	<u>2,199</u>	<u>195,577</u>
Transfers in (out)	<u>(144,874)</u>	<u>6,754</u>	<u>16,161</u>	<u>121,959</u>
Net Increase in Fund Balances	66,644	29,570	48,829	371,089
Fund Balances, July 1, 1984	<u>487,787</u>	<u>163,798</u>	<u>443,655</u>	<u>3,922,486</u>
Fund Balances, June 30, 1985	<u>\$ 554,431</u>	<u>\$193,368</u>	<u>\$492,484</u>	<u>\$4,293,575</u>

See the notes accompanying the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. Definition of the Reporting Entity

The General Purpose Financial Statements present information on the financial activities of the State of California (State) over which the Governor, the State Legislature, and other elected officials have direct or indirect governing and fiscal control. The financial statements include accounts of various boards, commissions, agencies, authorities, retirement systems, the workers' compensation insurance fund, and the state universities.

2. Summary of Significant Accounting Policies

A. Basis of Presentation

The accompanying financial statements present the financial position and the results of operations of the State for the year ended June 30, 1985. Except for the University of California, as explained below, the financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board, by the American Institute of Certified Public Accountants, and by the Financial Accounting Standards Board. The financial statements of the University of California have been prepared in conformity with generally accepted accounting principles as prescribed by the National Association of College and University Business Officers and by the American Institute of Certified Public Accountants.

The University of California receives an annual appropriation from the General Fund of the State. For the year ended June 30, 1985, approximately \$1.45 billion was accrued or disbursed from the General Fund to the University of California. This amount is recorded as revenues and expenditures in both the General Fund and the University of California Funds and is reported as such in the accompanying financial statements. Thus, these revenues and expenditures are reported twice.

Included in the State's General Purpose Financial Statements are the financial statements of the State Compensation Insurance Fund as of and for the year ended December 31, 1984. The State Compensation Insurance Fund represents 12.1 percent and 35.4 percent, respectively, of the assets and revenues of the Enterprise Funds.

B. Fund Accounting

The financial activities of the State accounted for in the accompanying financial statements have been classified as follows:

Governmental Fund Types

The governmental fund types are used primarily to account for services provided to the general public without charging directly for those services. The State has three governmental fund types:

The General Fund is the main operating fund of the State. It accounts for transactions related to resources obtained and used for those services that do not need to be accounted for in another fund.

Special Revenue Funds account for transactions related to resources obtained from dedicated revenue sources (other than for expendable trusts or major capital projects) that are legally restricted to expenditures for specified purposes.

Capital Projects Funds account for transactions related to resources obtained and used to acquire or construct major capital facilities.

Proprietary Fund Types

The proprietary fund types present financial data on state activities that are similar to those found in the private sector. Users are charged for the goods or services provided. The proprietary fund types are as follows:

Enterprise Funds account for goods or services provided to the general public on a continuing basis either where the State intends that all or most of the cost involved are to be financed by user charges or where periodic measurement of the results of operations is appropriate for management control, accountability, or other purposes.

Internal Service Funds account for goods or services provided to other funds, agencies, departments, or governments on a cost-reimbursement basis.

Fiduciary Fund Types

The fiduciary fund types are used to account for assets held by the State either as a trustee or as an agent for individuals, private organizations, other governments, or other funds. The fiduciary fund types are as follows:

Expendable Trust Funds account for assets held in a trustee capacity where both principal and income may be expended in the course of a fund's designated operations.

Pension Trust Funds account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems.

Agency Funds account for assets held by the State as an agent for individuals, private organizations, other governments, or other funds. They are custodial in nature and do not measure the results of operations.

General Long-Term Obligations Account Group

This account group records unmatured general obligation bonds and other long-term obligations generally expected to be financed from governmental funds.

University of California

The University of California uses the following types of funds to account for its activities:

Current Funds account for unrestricted funds that are expendable in pursuing the objectives of the University of California, over which the Regents of the University of California (Regents) retain control, and for externally restricted funds that may be used only in accordance with specified purposes.

Loan Funds account for resources available primarily for loans to students. In addition, resources are also available for loans to faculty and staff.

Endowment and Similar Funds--Endowment funds are invested in perpetuity, and the income is used in accordance with restrictions imposed by donors. Funds functioning as endowments are established by the Regents, and both principal and income may be expended.

Plant Funds account for resources available to acquire properties, to service the debt related to properties, to provide for the renewal and replacement of properties, and to account for funds invested in properties. Fixed assets of major laboratories of the U.S. Department of Energy are federally owned and are not included in the plant funds.

Retirement System Funds account for assets and liabilities of the University of California Retirement System. Certain employees of the University of California are members of the Public Employees' Retirement System.

C. Basis of Accounting

Governmental Fund Types, Expendable Trust Funds, and Agency Funds

The accounts of these fund types are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable

and available, and expenditures are recorded at the time the liabilities are incurred. The State's accounting practices include an exception to the modified accrual basis of accounting for vacation leave expenditures. These expenditures are recorded when paid because there is no satisfactory basis for determining the current liability. However, the liability for earned vacation of academic year faculty of the California State University and the special schools of the State Department of Education is accrued at June 30, as explained in Note 9.

Other accounting practices of the State include the recording of inventory items as expenditures when the items are purchased and the use of encumbrance accounting for budgetary control purposes. On the financial statements prepared in accordance with generally accepted accounting principles, encumbrances are shown as a reservation of fund balance.

Proprietary Fund Types and Pension Trust Funds

The accounts of these fund types are reported using the accrual basis of accounting except that vacation compensation is generally expensed when leave is taken. The amount of compensation representing such unused vacation time is not material and, therefore, is not generally reported in the financial statements.

University of California

The University of California funds are accounted for on the accrual basis of accounting. Accrued compensated absences and other immaterial accruals and deferrals are omitted.

D. Fixed Assets

General Fixed Assets Account Group

The General Fixed Assets Account Group is not presented on the Combined Balance Sheet.

Proprietary Fund Types

Fixed assets, consisting of property, plant, and equipment, are stated either at cost or at fair market value at the date of acquisition, less accumulated depreciation. (See Note 8 for detail.) Water projects, which represent 74.7 percent of the depreciable fixed assets of the Proprietary Funds, are depreciated over their service lives ranging from 30 to 100 years. Toll bridge facilities, which represent 16.7 percent of the depreciable fixed assets of the Proprietary Funds, are not depreciated. Most of the remaining assets are depreciated over their estimated service lives using the straight-line method of depreciation.

University of California

Plant and equipment assets are recorded at cost, if purchased. They are recorded at fair market at the date of acquisition, if donated. The fixed assets of the plant funds are not depreciated.

E. Budgetary Accounting

The State's annual budget is prepared on a modified accrual basis. The Governor recommends a budget for approval by the Legislature each fiscal year. Under California law, the State cannot adopt a spending plan that exceeds anticipated revenues.

Under the State Constitution, money may be drawn from the Treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations. The budget can be amended throughout the year by special legislative appropriations, budget revisions, or executive orders. Amendments to the initial budget for fiscal year 1984-85 were legally made, and they are included in the budget data in the accompanying financial statements.

Appropriations are generally available for expenditure or encumbrance either in the fiscal year appropriated or for a period of three years if the legislation does not specify a period of availability. Some appropriations continue indefinitely and are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period of availability of the appropriation. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

State agencies are responsible for exercising budgetary control and ensuring that appropriations are not overspent. In addition, the State Controller controls appropriations and will not disburse funds in excess of an appropriation.

3. Legal (Budgetary) Basis Financial Statements

A. Budgeted Revenues

In the annual budgeting process, the Governor estimates revenues. However, revenues are not included in the budget adopted by the Legislature.

B. Reconciliation of Legal Basis to GAAP Basis

The State of California annually reports the State's financial condition based on generally accepted accounting principles and also based on the State's legal provisions (legal basis). The State of California Annual Report (the legal basis financial report) is prepared in accordance with legal and regulatory requirements and is used for reporting on the execution of the State's budget. The accounting records of state agencies are maintained on the legal basis for the primary purpose of maintaining accountability of the State's budget and other fiscal legislation; these records are used as the basis for audit. After the legal basis report is prepared, adjustments are made to prepare the GAAP basis financial statements.

The accompanying Combined Statement of Revenues, Expenditures, and Changes in Fund Balances -- Budget and Actual (Legal Basis) is compiled on the legal basis. This statement is reconciled to the General Purpose Financial Statements prepared in accordance with generally accepted accounting principles as shown below. The primary differences between the legal basis accounting practices and generally accepted accounting principles are as follows:

Encumbrances

Encumbrances--goods and services that are ordered but not received by the end of the year--are recorded as expenditures on the legal basis. On the GAAP basis, they are reported as a reservation of fund balance, reduced to reflect anticipated reimbursements.

Accrued Expenditures of the California Medical Assistance Program

California Medical Assistance Program expenditures are, by law, accounted for on a cash basis. They are reported on the accrual basis in accordance with generally accepted accounting principles.

Advances and Loans Receivable

Loans made to other funds or to other governments are recorded as expenditures on the legal basis. However, in accordance with generally accepted accounting principles, these loans are recorded as assets.

Accrued Liability for Tax Overpayments

A liability for tax overpayments is not recognized on the legal basis. It is accrued in accordance with generally accepted accounting principles.

Accrued Liability for Compensated Absences

A liability for compensated absences is not recognized on the legal basis. As discussed in Note 9, the liability for earned vacation of faculty of the California State University and of the special schools of the State Department of Education is accrued in the General Fund in accordance with generally accepted accounting principles.

Restatement of Fund Balance

The beginning fund balance of the General Fund on the legal basis is adjusted to reflect the difference between the net expenditures and revenues that were accrued the previous June 30 and the amount of actual revenues and net expenditures that were subsequently realized. The beginning fund balance on the GAAP basis is not affected by these adjustments.

Reclassifications and Miscellaneous

Certain reclassifications are necessary to present the financial statements in accordance with generally accepted accounting principles. The major reclassifications are 1) reporting California State University student fees as revenue rather than as reimbursements, 2) reporting health care receipts from other funds as reimbursements rather than as revenue, and 3) reporting the Contingency Reserve for Economic Uncertainties as a designation of fund balance rather than as a reservation of fund balance. The miscellaneous adjustments relate to liabilities for lawsuits that are not recognized on the legal basis unless money has been appropriated and tax payments under appeal that are recognized as revenue on the legal basis.

STATE OF CALIFORNIA
GENERAL FUND
RECONCILIATION OF LEGAL BASIS TO GRAP BASIS
AS OF AND FOR THE YEAR ENDED JUNE 30, 1965
(IN THOUSANDS)

	ADJUSTMENTS TO THE LEGAL BASIS								
	Legal Basis	Encumbrances	Accrued Expenditures of the California Medical Assistance Program	Advances and Loans Receivable	Accrued Liability for Tax Overpayments	Accrued Liability for Compensated Absences	Restatement of Fund Balance	Reclassifications and Miscellaneous	GRAP Basis
ASSETS									
Cash and pooled investments	\$ 1,276,726							\$ (73,129)	\$ 1,203,597
Receivables (net)	82,082								82,082
Due from other funds	1,083,552		\$ 62,221					6,579	1,152,352
Due from other governments	12,602								12,602
Prepaid expenses	102,266							129,633	231,899
Other assets	293							(129,633)	293
Advances and loans receivable	129,633			\$ 402,967					402,967
Total Assets	\$ 2,687,154	\$ 0	\$ 62,221	\$ 402,967	\$ 0	\$ 0	\$ 0	\$ 166,550	\$ 3,085,792
LIABILITIES AND FUND EQUITY									
Liabilities									
Accounts payable	\$ 552,548	\$ (189,303)						\$ 8,665	\$ 371,910
Due to other funds	443,347	(88,148)	\$ 457,601					(277)	812,523
Due to other governments	196,848	375						12,660	209,883
Tax overpayments					\$ 83,006				83,006
Deposits	90								90
Compensated absences payable						\$ 67,629			67,629
Advance collections	30,055							92,301	122,356
Accrued interest payable	47,621								47,621
Other liabilities	16,434								16,434
Total Liabilities	1,286,943	(277,076)	457,601		83,006	67,629		113,349	1,731,452
Fund Equity									
Fund balances									
Reserved for encumbrances		277,076							277,076
Reserved for advances and loans									402,967
Contingency reserve for economic uncertainties	1,337,092		(395,380)					(791,077)	
Unreserved									
Designated for subsequent years' expenditures	63,119								63,119
Designated for economic uncertainties									
Total Fund Equity	1,400,211	277,076	(395,380)	402,967	(83,006)			611,178	1,354,340
Total Liabilities and Fund Equity	\$ 2,687,154	\$ 0	\$ 62,221	\$ 402,967	\$ 0	\$ 0	\$ 0	\$ 166,550	\$ 3,085,792

REVENUES

Taxes	\$25,514,709		\$ 44,443	\$ 2,120	\$ (98,188)	\$25,463,084
Intergovernmental	30,812				35,886	66,698
Licenses and permits	11,935				117,444	129,379
Natural resources	22,110					22,110
Charges for services	44,425					44,425
Fees	61,648				202,498	264,146
Penalties	12,102				1,116	13,218
Interest	476,995				(321,993)	476,712
Miscellaneous	377,665					47,033
Total Revenues	<u>26,552,401</u>		<u>44,443</u>	<u>2,120</u>	<u>(63,237)</u>	<u>26,526,805</u>

EXPENDITURES

Current						
General government	1,039,387	\$ 3,228		18,915	42,349	1,103,553
Education	13,538,829	(13,984)		8,836	187,870	13,810,903
Health and welfare	8,008,707	(20,211)	\$ 830	(55,716)	(219,611)	7,842,942
Resources	387,913	(6,467)		(1,414)	380,032	380,702
State & consumer services	182,353	1,093		(2,740)	(4,211)	180,702
Business & transportation	62,576	(3,016)		664	1	56,005
Correctional programs	1,046,215	(2,822)		(8,464)		1,035,130
Property tax relief	946,929	(3,991)		1,912		944,850
Capital outlay	9,155					9,155
Debt service	201,370				1,888	203,258
Principal retirement	174,327				(240)	172,571
Interest & fiscal charges						
Total Expenditures	<u>25,597,761</u>	<u>(45,970)</u>	<u>830</u>	<u>(38,011)</u>	<u>7,996</u>	<u>25,739,101</u>

OTHER FINANCING SOURCES (Uses)

Operating transfers in	74,142	(4)			(40,003)	34,135
Operating transfers out	(159,325)	(186)			17,556	(141,957)
Total Other Financing Sources (Uses)	<u>(85,183)</u>	<u>(192)</u>			<u>(22,447)</u>	<u>(107,822)</u>
Excess of Revenues and Other Sources Over (Under) Expenditures and Other Uses	869,457	45,970	(830)	40,131	(93,680)	679,882
Fund Balance July 1, 1984, as restated	530,754	231,106	(127,449)	(40,131)	(86,219)	674,458
Fund Balance, June 30, 1985	<u>\$ 1,400,211</u>	<u>\$ 277,076</u>	<u>\$ (83,006)</u>	<u>\$ 0</u>	<u>\$ (179,899)</u>	<u>\$ 1,354,340</u>

**STATE OF CALIFORNIA
SPECIAL REVENUE FUND RECONCILIATION
OF LEGAL BASIS TO GAAP BASIS
AS OF JUNE 30, 1985
(IN THOUSANDS)**

Fund Balances, June 30, 1985 - Legal Basis	\$1,091,669
Encumbrances	750,746
Advances or loans to other funds or to other governments	438,070
Commitments for future mass transportation projects	45,531
Deposits for condemnation proceedings	27,296
Other	<u>(59,694)</u>
Fund Balances, June 30, 1985 - GAAP Basis	<u>\$2,293,618</u>

4. Cash and Pooled Investments

The State Treasurer and the Treasurer of the Regents of the University of California each administers a pooled money investment program. These programs enable the treasurers to combine available cash from all funds within their respective systems and to invest cash that exceeds current needs.

The cash and pooled investments account includes cash on hand, cash deposited with banks, and securities consisting primarily of certificates of deposit, commercial paper, United States government issues, and federal agency obligations. Included in this account are securities that the State Treasurer sold or purchased under agreements to repurchase or resell the securities at later dates.

The State Treasurer has agreements to maintain cash on deposit with certain banks that does not bear interest income to the State. Income earned on these deposits compensates the banks for services and uncleared checks that are deposited in the State's accounts. At June 30, 1985, the agreements provided that the State maintain approximately \$50 million on deposit to compensate the banks for services and \$179 million to compensate the banks for uncleared checks.

As of June 30, 1985, the average remaining life of the securities in the pooled money investment program administered by the State Treasurer was approximately ten months. These securities are reported at amortized cost. The average remaining life of the securities in the pooled money investment program administered by the Treasurer of the Regents of the University of California was less than one year. These securities are reported at cost. Market values for the State Treasurer's portfolio and the University of California's portfolio approximate book values at June 30, 1985.

5. Investments

The following schedule shows the amortized cost and market value of investments, other than pooled investments, for all funds. Totals are those reported at June 30, 1985, except for the State Compensation Insurance Fund, which is reported as of December 31, 1984 (in thousands):

	<u>Amortized Cost</u>	<u>Market Value</u>
<u>Enterprise Funds</u>		
State Compensation Insurance Fund	\$ 1,589,311	\$ 1,449,468
Housing Finance Fund	747,128	751,585
Other Enterprise Funds	<u>233,500</u>	Unavailable
Total	<u>\$ 2,569,939</u>	
<u>Trust and Agency Funds</u>		
Public Employees' Retirement System	\$26,171,931	\$28,604,006
State Teachers' Retirement System	12,508,046	13,062,298
Legislators' Retirement System	45,226	46,168
Judges' Retirement System	323	323
Deferred Compensation Fund	503,280 ^a	528,285
Other Trust and Agency Funds	<u>70,853</u>	Unavailable
Total	<u>\$39,299,659</u>	
<u>University of California</u>		
Endowment and Similar Funds	\$ 472,994	\$ 685,378 ^b
University of California Retirement System	<u>4,026,524</u>	<u>5,654,416</u>
Total ^c	<u>\$ 4,499,518</u>	<u>\$ 6,339,794</u>

^aThis amount does not represent amortized cost; it includes cost and accumulated earnings.

^bThis amount does not include the market value of real estate investments reported at amortized cost of \$11.9 million.

^cOn the combined balance sheet, the University of California investments (in thousands) of \$6,127,410 consist of \$472,994 (at amortized cost) for the Endowment and Similar Funds and \$5,654,416 (at market value) for the University of California Retirement System.

6. Restricted Assets

The following schedule presents a summary of the legal restrictions on assets of the Enterprise Funds and the purposes for which the assets were restricted as of June 30, 1985 (in thousands):

<u>Purpose</u>	<u>Restricted Assets</u>		
	<u>Cash and Pooled Investments</u>	<u>Investments</u>	<u>Due From Other Funds</u>
Debt service	\$ 332	\$53,846	\$670,180
Construction	13		189,705
Equipment repair and replacement			20,583
Deposits	<u>1,516</u>	<u> </u>	<u>425</u>
Total Restricted Assets	<u>\$1,861</u>	<u>\$53,846</u>	<u>\$880,893</u>

7. Deferred Charges

The deferred charges account in the Enterprise Fund Type represents operating costs and depreciation that will be recognized as expenses over the remaining life of long-term State Water Project contracts because these costs are billable in future years. In addition, the account includes imputed interest earnings on unrecovered capital and operating costs that are recorded as deferred charges until they are billed in future years under the terms of the State Water Project contracts.

8. Fixed Assets

The following schedule presents a summary of the fixed assets of the Proprietary Fund Types and the University of California as of June 30, 1985 (in thousands):

	<u>Proprietary Fund Types</u>		University of California
	<u>Enterprise</u>	<u>Internal Service</u>	
State water projects	\$2,812,740		
Toll facilities	579,053		
Other land, improvements, buildings, and equipment	412,198	\$182,867	\$4,388,594
Construction in progress	<u>359,833</u>	<u> </u>	<u>127,766</u>
Total Fixed Assets	4,163,824	182,867	4,516,360
Less accumulated depreciation	<u>445,247</u>	<u>79,516</u>	<u> </u>
Net Fixed Assets	<u>\$3,718,577</u>	<u>\$103,351</u>	<u>\$4,516,360</u>

9. Compensated Absences Payable

As of June 30, 1985, the State's liability for compensated absences related to accumulated vacation leave amounted to approximately \$406 million. Of this amount, \$336 million is reported in the General Long-Term Obligations Account Group, \$2 million is reported in the Proprietary Fund Types, and \$68 million for earned vacation compensation of academic year faculty of the California State University and of the special schools of the State Department of Education is recorded as a current liability in the General Fund. Accumulated sick leave balances do not vest to employees. However, unused sick leave balances convert to service credits upon retirement.

10. General Obligation Bonds

The State Constitution permits the State to issue general obligation bonds for specific purposes and in such amounts as approved by two-thirds of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used first to support the public school system and public institutions of higher education and second to service the debt on outstanding general obligation bonds. Enterprise funds reimburse the General Fund for the debt service provided on their behalf. In 1969, the City and County of San Francisco also agreed to reimburse the State for debt service on certain general obligation bonds for harbor development and improvement.

A. Changes in Bond Indebtedness

The following schedule summarizes the changes in general obligation bond debt for the year ended June 30, 1985 (in thousands):

	<u>Balance July 1, 1984</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance June 30, 1985</u>
General Long- Term Obligations	\$2,234,900	\$ 740,000	\$203,258	\$2,771,642
Enterprise Funds	<u>4,667,915</u>	<u>410,000</u>	<u>269,460</u>	<u>4,808,455</u>
Total General Obligation Bonds	<u>\$6,902,815</u>	<u>\$1,150,000</u>	<u>\$472,718</u>	<u>\$7,580,097</u>

General obligation bonds that are directly related to and expected to be paid from the resources of enterprise funds are included within the accounts of such funds in the accompanying financial statements. However, the General Fund may be liable for the payment of any principal and interest on these bonds that is not met from the resources of such funds.

B. Bonds Outstanding and Bonds Authorized But Unissued

The following schedule shows general obligation bonds outstanding and bonds authorized but unissued as of June 30, 1985 (in thousands):

	<u>Outstanding</u>	<u>Authorized But Unissued</u>
<u>General Long-Term Obligations</u>		
New Prison Construction	\$ 435,000	\$ 345,000
State School Building Lease- Purchase	365,235	555,000
Clean Water	273,250	355,000
Clean Water and Water Conservation	241,570	95,000
State Construction	230,300	
State Beach, Park, Recreational and Historical Facilities	198,170	
State, Urban, and Coastal Park	183,990	30,000
County Jail Capital Expenditure	173,325	355,000
State Parklands	161,575	95,000
Safe Drinking Water	150,485	90,000
Health Science Facilities	89,585	
Community College Construction	79,250	
Higher Education Construction Program	71,145	
Recreation and Fish and Wildlife Enhancement	27,000	
California Park and Recreational Facilities	25,000	345,000
Junior College Construction	20,100	
Fish and Wildlife Habitat Enhancement	20,000	65,000
Harbor Development	16,662	
Lake Tahoe Acquisitions	10,000	75,000
Hazardous Substance Cleanup		100,000
Senior Center		50,000
	<hr/>	<hr/>
Total General Long-Term Obligations	<u>2,771,642</u>	<u>2,555,000</u>
<u>Enterprise Funds</u>		
California Veterans	2,802,175	340,000
California Water Resource Development	1,412,640	180,000
State School Building Aid	578,090	40,000
First-Time Home Buyers	15,000	185,000
Harbor Development	550	
	<hr/>	<hr/>
Total Enterprise Funds	<u>4,808,455</u>	<u>745,000</u>
Total General Obligation Bonds	<u>\$7,580,097</u>	<u>\$3,300,000</u>

C. Debt Service Requirements

The following schedule shows the debt service requirements for general obligation bonds, including interest of \$5.4 billion, as of June 30, 1985 (in thousands):

<u>Year Ending June 30</u>	<u>General Long-Term Obligations</u>	<u>Enterprise Funds</u>
1986	\$ 430,850	\$ 564,213
1987	411,058	543,095
1988	389,848	500,581
1989	362,546	481,228
1990	341,229	456,437
Thereafter	<u>2,504,327</u>	<u>6,079,572</u>
Total	<u>\$4,439,858</u>	<u>\$8,625,126</u>

11. Revenue Bonds and Notes Payable

With approval in advance from the State Legislature, certain state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the earnings of the respective enterprise funds of the agencies listed in Section B of this footnote or from resources of certain Plant Funds or Loan Funds of the University of California. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

The Department of Water Resources, the California State University, the California Transportation Commission, and the University of California issued revenue bonds to acquire or construct state facilities. The California Housing Finance Agency, the Department of Veterans Affairs, the California National Guard, and the California Student Loan Authority issued revenue bonds to allow the State to make loans to finance housing development, to finance the acquisition of farms and homes by California veterans and National Guard members, and to purchase federally insured student loans from lending institutions. When loans financed by these revenue bonds are fully paid, the farms and homes become the property of private individuals or entities.

A. Changes in Bond Indebtedness

The following schedule summarizes the changes in revenue bond debt for the year ended June 30, 1985 (in thousands):

	<u>Balance July 1, 1984</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance June 30, 1985</u>
Enterprise Funds	\$3,491,967	\$1,155,189	\$284,079	\$4,363,077
University of California	<u>208,611</u>	<u> </u>	<u>6,231</u>	<u>202,380</u>
Total Revenue Bonds	<u>\$3,700,578</u>	<u>\$1,155,189</u>	<u>\$290,310</u>	<u>\$4,565,457</u>

B. Revenue Bonds Outstanding

The following schedule shows revenue bonds outstanding as of June 30, 1985 (in thousands):

	<u>Outstanding</u>
<u>Enterprise Funds</u>	
California Housing Finance Agency	\$2,251,266
Department of Water Resources	1,008,504
Department of Veterans Affairs	655,850
California State University	186,188
California Student Loan Authority	117,660
California Transportation Commission	105,296
California National Guard	<u>38,313</u>
Total Enterprise Funds	<u>4,363,077</u>
<u>University of California</u>	
Regents of the University of California	<u>202,380</u>
Total Revenue Bonds	<u>\$4,565,457</u>

Outstanding revenue bonds totaling \$7.1 million for Hastings College of the Law are not included in the accompanying financial statements.

C. Debt Service Requirements

The following schedule shows the debt service requirements for revenue bonds, including interest of \$8.2 billion, as of June 30, 1985 (in thousands):

<u>Year Ending June 30</u>	<u>Enterprise Funds</u>	<u>University of California</u>
1986	\$ 479,034	\$ 17,050
1987	476,490	16,985
1988	475,353	16,969
1989	471,203	17,038
1990	470,233	16,666
Thereafter	<u>9,945,876</u>	<u>318,568</u>
Total	<u>\$12,318,189</u>	<u>\$403,276</u>

D. Notes Payable

Certain state agencies issued short-term notes, secured by specific revenue sources, to provide temporary financing. The following schedule shows outstanding notes payable as of June 30, 1985 (in thousands):

<u>Enterprise Funds</u>	<u>Outstanding</u>
State Public Works Board	\$106,464
Student Loan Authority	41,600
Department of Transportation	5,000
California Housing Finance Agency	<u>2,900</u>
Total Notes Payable	<u>\$155,964</u>

E. Early Extinguishments of Debt

During April 1985, the Department of Water Resources issued \$239,505,000 of Central Valley Project Facilities Revenue Bonds - Series G and used \$234,563,400 of the proceeds to satisfy a debt of \$200 million for Series B revenue bonds. The department invested the \$234,563,400 in United States government securities and placed the securities in irrevocable escrow with the State Treasurer. The investment and interest will be sufficient to redeem the Series B revenue bonds through December 1, 1992, when the bond principal for the remaining ten years will also be retired.

Similarly, during July 1981, the California Transportation Commission satisfied a debt of \$20 million for San Francisco Bay Toll Bridge revenue bonds by depositing United States government securities in irrevocable escrow with the State Treasurer. These securities were purchased in May 1980 for \$18,295,313; this amount and the interest it earns are sufficient to redeem the revenue bonds upon maturity. The first, second, and third installments of \$5 million each have since matured and have been paid from the escrow account.

Since the escrow arrangements effectively release the Department of Water Resources and the California Transportation Commission from their obligations for the \$200 million and the remaining \$5 million in revenue bonds, the liability for the bonds is not included on the combined balance sheet, nor are the related investments.

12. No-Commitment Debt

The Legislature created various authorities to provide private entities with a low-cost source of capital financing for constructing facilities deemed to be in the public interest. This debt is secured solely by the credit of the private entities and is administered by trustees independent of the State. The State has no obligation for this debt. Accordingly, these bonds are not reported in the accompanying financial statements.

The following schedule shows no-commitment bonds outstanding as of June 30, 1985 (in thousands):

	<u>Outstanding</u>
Health Facilities	\$2,017,943
Pollution Control	1,229,628
Education Facilities	499,980
Alternate Energy Source	<u>39,285</u>
Total No-Commitment Debt	<u>\$3,786,836</u>

13. Commitments

A. Leases

The aggregate amount of lease commitments for facilities and equipment, excluding those of the University of California, in effect as of June 30, 1985, is approximately \$650 million. This amount does not include any future escalation charges for real estate taxes and operating expenses. Most state leases are classified as operating leases, and they contain clauses providing for termination. It is expected that in the normal course of business most of these leases will be replaced by similar leases.

The State has also entered into some lease-purchase agreements to acquire office buildings and electronic data processing equipment. The acquisition or development of the office buildings is financed by joint powers authorities, nonprofit corporations, and private corporations who then lease the facilities to the State. Upon expiration of these leases, title to the facilities and equipment will pass to the State.

The minimum lease commitments are summarized below (in thousands):

<u>Year Ending June 30</u>	<u>Operating Leases</u>	<u>Capital Leases</u>	<u>Total</u>
1986	\$124,953	\$ 6,518	\$131,471
1987	105,945	12,139	118,084
1988	77,198	12,960	90,158
1989	50,641	12,737	63,378
1990	34,484	12,356	46,840
Thereafter	<u>134,899</u>	<u>224,077</u>	<u>358,976</u>
Total Minimum Lease Payment	<u>\$528,120</u>	<u>280,787</u>	<u>\$808,907</u>
Less amounts representing interest		<u>166,050</u>	
Present Value of Net Minimum Lease Payment		<u>\$114,737</u>	

Lease expenditures for the year ended June 30, 1985, amounted to approximately \$155 million.

University of California rental expenditures for the years ended June 30, 1985 and 1984, totaled \$32 million and \$34 million, respectively. Minimum payments required under capital and noncancellable operating leases in fiscal year 1985-86 are \$9.7 million and decrease in amount thereafter.

B. Loan and Construction

As of June 30, 1985, loan programs for housing, school building aid, harbors and waterways, domestic water supply systems, energy conservation, and economic development had loan commitments totaling approximately \$839 million. These commitments are expected to be funded from existing program resources and from the proceeds of revenue and general obligation bonds to be issued. The State had commitments for approximately \$49 million for the construction of water

projects and the construction and rehabilitation of toll bridge facilities. Construction projects of the University of California, totaling \$90 million, had been authorized as of June 30, 1985. Of this amount, \$50 million will be funded from unexpended plant funds and \$40 million from other sources. These loan and construction commitments are not included in the accompanying financial statements.

C. Encumbrances

At June 30, 1985, encumbrances of the Special Revenue Funds totaled \$751 million. This amount does not include commitments of \$1.1 billion for various highway projects because the future expenditures related to these commitments are expected to be reimbursed primarily from proceeds of approved federal grants. The ultimate liability will not accrue to the State.

D. New Prison Construction

Chapter 273 of the Statutes of 1981 and Chapter 4 of the Statutes of 1984 authorized the issuance of \$795 million for new prison construction general obligation bonds to finance the State's new prison construction program. As of June 30, 1985, the State had issued \$450 million of these bonds. Of this \$450 million in bond proceeds, \$168 million has been expended, \$60 million is encumbered, and \$222 million is designated for subsequent years' expenditures.

The Legislature has appropriated \$312 million in excess of new prison construction bonds sold as of June 30, 1985. The additional money to fully fund the appropriations of the Legislature will be obtained from the future sale of general obligation bonds. This \$312 million is not included in the financial statements.

14. Major Tax Revenues

Tax revenues for the year ended June 30, 1985, are as follows (in thousands):

	<u>General Fund</u>	<u>Special Revenue Funds</u>	<u>Expendable Trust Funds</u>
Sales and use	\$ 9,666,514	\$712,909	
Personal income	10,799,539		
Bank and corporation	3,703,678		
Unemployment insurance			\$2,181,319
Disability insurance			1,005,652
Other	<u>1,293,353</u>	<u>98,719</u>	<u>12,845</u>
Total	<u>\$25,463,084</u>	<u>\$811,628</u>	<u>\$3,199,816</u>

15. Pension Trusts

A. General

The State administers five defined benefit contributory retirement plans: the Public Employees' Retirement System, the State Teachers' Retirement System, the University of California Retirement System, the Judges' Retirement System, and the Legislators' Retirement System. The schedule below shows the number of members in each of the retirement plans as of June 30, 1985:

	<u>State</u>	<u>Other</u>	<u>Benefit Recipients</u>	<u>Total</u>
Public Employees'	187,139	354,338	223,488	764,965
State Teachers'	207	302,379	103,803	406,389
University of California	81,691		9,632	91,323
Judges'	834	497	812	2,143
Legislators'	177		204	381

These retirement systems are accounted for in separate funds. Except for the Legislators' Retirement System and the University of California Retirement System, these are statewide, multi-employer retirement plans. The following schedule presents a summary of the annual contributions to the retirement systems by the State, public agencies, and members for fiscal year 1984-85 (in thousands):

	<u>State</u>	<u>Public Agencies</u>	<u>Members</u>	<u>Total Contributions</u>
Public Employees'	\$836,404	\$936,754	\$627,644	\$2,400,802
State Teachers'	328,712	582,248	582,778	1,493,738
University of California	195,109		125,614	320,723
Judges'	18,914	4,290	7,216	30,420
Legislators'	736		299	1,035

The University of California Retirement System is reported as part of the University of California within the General Purpose Financial Statements. The other four systems are reported within the Fiduciary Fund Type.

B. Unfunded Actuarial Liability

Independent actuaries evaluate the adequacy of the financing of the five retirement systems. The contributions reported for the Public Employees' and the University of California retirement systems include amortization of the unfunded

actuarial liability over a period not to exceed 30 years. The long-term financing requirements of the other three systems are significantly greater than the contributions provided in state law. The following schedule shows the unfunded actuarial liability for the Public Employees', State Teachers', University of California, Judges', and the Legislators' retirement systems at the dates indicated (in millions):

	<u>Date of Last Actuarial Valuation</u>	<u>State Share of Unfunded Actuarial Liability</u>	<u>Total Unfunded Actuarial Liability</u>
Public Employees'	6/30/84	\$6,598	\$12,520
State Teachers'	6/30/83	Unknown	10,139
University of California	6/30/85	876.4	876.4
Judges'	6/30/84	Unknown	620
Legislators'	6/30/84	20	20

The Education Code requires the State to provide supplemental funding to the State Teachers' Retirement System in order to reduce that system's unfunded actuarial liability. This code requires that, beginning July 1, 1980, annual state contributions of \$144 million to the State Teachers' Retirement System be increased or decreased to reflect changes in the California Consumer Price Index. For the 1984-85 fiscal year, the \$144 million increased to \$216 million because of changes in the California Consumer Price Index. The Education Code also provides for additional annual contributions as follows:

<u>Fiscal Year</u>	<u>Amount</u>	<u>Fiscal Year</u>	<u>Amount</u>
1985-86	\$100 million	1991-92	\$220 million
1986-87	120 million	1992-93	240 million
1987-88	140 million	1993-94	260 million
1988-89	160 million	1994-95	280 million
1989-90	180 million	Thereafter	280 million
1990-91	200 million		

Beginning in fiscal year 1994-95, the additional annual contributions of \$280 million must be indexed to the California Consumer Price Index.

Pension expenses related to the University of California Retirement System were \$195.1 million (including \$8.1 million for a special contribution and contributions to voluntary plans) for fiscal year 1984-85. In 1983, the State deferred the employer contribution appropriation to the University of California. The State agreed to pay the amount deferred in actuarially equivalent annual installments over the next 30

years. The outstanding amount of \$65.9 million is reported as a receivable in the Current Funds of the University of California and as an interfund receivable and payable between the University of California's Current and Retirement System Funds. However, the State will pay this amount from future years' appropriations. The State's General Fund does not recognize liabilities for amounts to be paid from future years' appropriations.

C. Change in Actuarial Assumptions

On December 12, 1984, the State Teachers' Retirement Board adopted a change in estimated rate of return on investments from 8.25 percent to 8.75 percent, reducing the unfunded actuarial liability from \$11.5 billion to \$10.1 billion.

16. Postretirement Health Care Benefits

In addition to providing pension benefits, the State also provides certain health care benefits for eligible retired employees and their survivors. The cost of retiree health care and dental benefits is recognized as an expenditure when the benefits are paid. The cost of providing these benefits for retirees in fiscal year 1984-85 was \$130.7 million, including \$28 million for the University of California.

17. Deferred Compensation Plan

The State has adopted a deferred compensation plan available to eligible state employees. Eligible employees may defer receiving portions of their salaries, thereby deferring taxation on those portions, until they are separated from service or face a serious financial emergency. The participants direct the plan administrator, the State, to invest the deferred amounts among nine investment options. The cost of administration and all funding are the responsibility of those participating in the plans. The State makes no contributions to the plan. However, the money in the plan is available for payment to the State's general creditors where permitted by the Legislature.

As of June 30, 1985, assets invested on behalf of the participants totaled approximately \$503 million. This amount is reported at cost plus accumulated earnings in an agency fund.

18. Guaranty Deposits

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to assure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

19. Segment Information - Enterprise Funds

Selected financial information by enterprise fund activity for major segments is shown in the schedule on the following page.

**ENTERPRISE FUND ACTIVITY
BY MAJOR SEGMENTS
(IN THOUSANDS)**

	Housing Loan	Water	State Compensation Insurance	Student Loans and School Building Aid	Toll Facilities	State University	Harbors and Waterways	Leasing of Public Assets	Other Enterprises
Operating Revenue	\$ 490,113	\$ 416,892	\$ 777,611	\$ 67,890	\$ 79,405	\$ 98,608	\$ 8,903	\$ 8,698	\$24,917
Operating Income	94,356	76,353	228,492	26,159	46,102	21,562	2,041	5,742	4,656
Net Income	163,199	4,340	228,492	31,235	33,808	16,410	17,596	5,827	12,048
Property, Plant, and Equipment									
Additions	47	169,408	10,850	6,263		19,963	15	1	93
Deductions	296				55				30
Total Assets	6,716,689	4,121,286	1,884,530	1,085,038	845,431	452,937	144,586	190,015	57,281
Bonds and Other Long-Term Liabilities									
Payable from operating revenues	5,870,016	2,824,046		1,091,095	128,786	186,188	2,171	111,465	300
Total Equity	574,047	1,063,760	494,226	(20,553)	707,070	223,838	139,499	73,437	50,904

The primary sources of Enterprise Fund revenues are as follows:

Housing Loan - Interest charged on contracts of sale of properties to California veterans and to California National Guard members, interest charged on program loans to finance the housing needs of persons and families of low and moderate income, loan origination fees, and interest earned on investments.

Water - Charges to local water districts, sale of excess power to public utilities, and interest earned on investments.

State Compensation Insurance - Premiums collected from California employers for insurance against workers' compensation claims and interest earned on investments. This information is as of and for the year ended December 31, 1984.

Student Loans and School Building Aid - Interest charged on loans to school districts for acquisition, construction, or rehabilitation of classroom facilities, income from the rental of portable classrooms to school districts, and interest charged on loans to students; \$20.4 million of the deficit results primarily from the write-down of loans receivable from school districts. The loans may be forgiven in accordance with statutory provisions.

Toll Facilities - Toll fees and interest earned on investments.

State University - Charges to students for housing and parking; student fees for campus unions, health centers, and self-supporting educational programs; and interest earned on investments.

Harbors and Waterways - Gasoline taxes related to boating activities, fees for boating registration and licensing, and interest earned on investments.

Leasing of Public Assets - Rental charges from the lease of public assets and interest earned on investments.

Other Enterprises - Canteen revenues and processing fees charged by various other departments and authorities.

20. Contingencies

A. Litigation

The State is a party to numerous legal proceedings, many of which normally recur in governmental operations. The following were accrued as a liability in the financial statements: legal proceedings that were decided against the State before June 30, 1985; legal proceedings that were in progress at June 30, 1985, and that were settled or decided against the State as of December 20, 1985; and those legal proceedings having a high probability of resulting in a decision against the State as of December 20, 1985, and for which amounts could be estimated. For Governmental Fund Types and Expendable Trust Funds, the portion of the liability that is expected to be paid within the next 12 months is recorded as a liability of the fund from which payment will be made; the remainder is shown as a liability of the General Long-Term Obligations Account Group. For other fund types, the entire liability is recorded in the fund involved. In addition, the State is involved in certain other legal proceedings that, if decided against the State, may require the State to make significant future expenditures or may impair future revenue sources. Because of the prospective nature of these proceedings, no provision for this potential liability has been made in the accompanying financial statements, nor can an estimate of the potential loss be made.

B. Federal Audit Exceptions

The State of California receives substantial funding from the federal government in the form of grants and contracts. The State is entitled to these resources only if it complies with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; the State may spend these resources only for eligible purposes. If audits disclose exceptions, the State may incur a liability to the federal government.

C. Insurance Program

The State has elected, with a few exceptions, to be self-insured against loss or liability. The State generally does not maintain reserves; losses are covered by appropriations in the year in which the payment occurs. Except for the University of California, workers' compensation benefits for self-insured agencies are initially paid by the State Compensation Insurance Fund. The State Compensation Insurance Fund estimated the liability for future workers' compensation claims against the State's self-insured agencies to be approximately \$293.6 million as of June 30, 1985. This liability is included in the accompanying financial statements in the General Long-Term Obligations Account Group. The

University of California is also self-insured, but it has placed assets with an independent trustee for the payment of workers' compensation. These assets are reported in the accompanying financial statements along with the related liability for future payments.

21. Reclassifications

The Enterprise Funds in the combined balance sheet reflect approximately \$4 billion of prior year receivable balances that were reclassified as advances and loans receivable. The reclassifications were made to better present these accounts in view of changed conditions and additional information that became available.

22. Subsequent Events

On August 13, 1985, the State of California issued \$2.3 billion in revenue anticipation notes to fund the State's cash flow needs for the 1985-86 fiscal year. These notes will mature on June 30, 1986.

From July 1, 1985, to December 20, 1985, the State sold \$585 million in general obligation bonds and \$737 million in revenue bonds.

On July 1, 1985, the University of California sold \$45.9 million in housing revenue bonds. On September 6, 1985, the University sold an additional \$43.5 million in Faculty Mortgage Revenue Bonds. On December 5, 1985, the University of California Parking System Bonds were refunded and replaced by issues for the Berkeley and Los Angeles campuses totaling \$10,359,000.

On October 3, 1985, the California State Lottery offered its first lottery tickets to the public. Through December 1985, ticket sales totaled approximately \$800 million. In accordance with the State Lottery Act of 1984, 50 percent of the proceeds must be paid in prizes. In addition, at least 34 percent of the lottery revenues must be allocated to the benefit of public education, and no more than 16 percent of the proceeds can be used for administrative costs.

STATISTICAL SECTION

STATE OF CALIFORNIA
SELECTED TAX REVENUE (LEGAL BASIS) BY SOURCE
COMPARATIVE YIELD OF STATE TAXES
FISCAL YEARS 1976-1985
(IN THOUSANDS)

Year Ending June 30	Retail Sales and Use	Personal Income	Bank and Corporation*	Cigarette	Inheritance, Estate, and Gift**	Insurance	Distilled Spirits	Horse Racing Revenues	Beer and Wine	Motor Vehicle Fuel***	Motor Vehicle Fees****
1976	\$3,742,524	\$ 3,086,611	\$1,286,515	\$268,610	\$316,648	\$241,224	\$104,697	\$ 96,117	\$20,616	\$ 766,555	\$ 749,935
1977	4,314,201	3,761,356	1,641,500	269,384	367,964	322,476	105,275	102,702	22,210	810,321	807,782
1978	5,030,438	4,667,887	2,082,208	273,658	365,092	387,560	109,088	111,591	22,972	850,181	924,410
1979	5,780,919	4,761,571	2,381,223	268,816	416,955	420,184	114,922	112,856	25,137	896,591	1,021,856
1980	6,623,521	6,506,015	2,510,039	290,043	465,611	446,228	112,757	127,002	26,183	852,752	1,096,640
1981	7,131,429	6,628,694	2,730,624	278,161	530,185	460,926	115,191	129,779	27,669	839,994	1,127,293
1982	7,689,023	7,483,007	2,648,735	276,824	482,300	454,984	111,151	119,626	28,372	833,446	1,373,354
1983	7,795,488	7,701,099	2,536,011	271,621	517,875	736,929	108,519	120,159	27,690	928,633	1,614,993
1984	8,797,865	9,290,279	3,231,281	263,231	236,452	457,490	107,983	141,001	29,450	1,213,167	1,906,290
1985	9,797,564	10,807,706	3,664,593	262,868	296,805	643,139	105,952	133,814	29,834	1,159,637	2,137,326

*Includes the corporation income tax.

**Proposition 6 of 1982 repealed the inheritance and gift taxes and imposed an estate tax equal to the maximum allowable federal estate tax credit, effective for decedents dying on or after June 9, 1982.

***Motor vehicle fuel tax (gasoline) and use fuel tax (diesel and liquefied petroleum gas).

****Registration and weight fees, motor vehicle license fees, and other fees.

Source: State Controller

**STATE OF CALIFORNIA
RATIO OF GENERAL LONG-TERM
BONDED DEBT TO PER CAPITA INCOME
FISCAL YEARS 1978-1985**

<u>Year Ending June 30</u>	<u>General Long-Term Bonded Debt (In Thousands)</u>	<u>Per Capita Debt</u>	<u>Per Capita Income</u>	<u>Ratio: Per Capita Debt to Per Capita Income</u>
1978	\$1,680,644	\$ 73.59	\$ 8,786	.84%
1979	1,727,920	74.30	9,859	.75
1980	1,755,886	73.87	11,021	.67
1981	1,685,352	69.59	12,105	.57
1982	1,791,913	72.56	12,617	.58
1983	2,074,159	82.39	13,257	.62
1984	2,234,900	87.20	14,592	.60
1985	2,771,642	105.12	15,096	.70

Sources: 1978-85, State Controller's Annual Reports; 1982, U.S. Department of Commerce, Bureau of Economic Analysis, and California Department of Finance estimates.

**STATE OF CALIFORNIA
COMPARISON OF NATIONAL TO STATE POPULATION
CALENDAR YEARS 1940-1984**

<u>Year</u>	<u>United States Population</u>	<u>Average Annual Percentage Increase</u>	<u>California Population</u>	<u>Average Annual Percentage Increase</u>	<u>California as Percent of United States</u>
1940	132,457,000		6,950,000		5.2
1950	151,868,000	1.4	10,643,000	4.4	7.0
1960	179,979,000	1.7	15,863,000	4.1	8.8
1970	203,984,000	1.3	20,039,000	2.4	9.8
1980	227,236,000	1.1	23,771,000	1.7	10.5
1981	229,518,000	1.0	24,216,000	1.9	10.6
1982	231,786,000	1.0	24,698,000	2.0	10.7
1983	233,981,000	.9	25,186,000	2.0	10.8
1984	236,108,000	.9	25,622,000	1.7	10.9

Sources: U.S. Department of Commerce, Bureau of the Census, Current Population Reports; California Department of Finance estimates.

**STATE OF CALIFORNIA
COMPARISON OF NATIONAL TO STATE PERSONAL INCOME
CALENDAR YEARS 1970-1984**

Year	United States		California		California as a Percent of United States
	Personal Income (In Millions)	Percent Change	Personal Income (In Millions)	Percent Change	
1970	\$ 803,922		\$ 90,295		11.2
1971	861,904	7.2	95,653	5.9	11.1
1972	944,852	9.6	104,191	8.9	11.0
1973	1,058,902	12.1	114,690	10.1	10.8
1974	1,162,203	9.8	128,142	11.7	11.0
1975	1,258,643	8.3	141,046	10.1	11.2
1976	1,385,201	10.1	156,940	11.3	11.3
1977	1,534,708	10.8	175,737	12.0	11.5
1978	1,726,185	12.5	202,282	15.1	11.7
1979	1,942,655	12.5	231,416	14.4	11.9
1980	2,156,715	11.0	261,946	13.2	12.1
1981	2,420,098	12.2	293,196	11.9	12.1
1982	2,575,759	6.4	312,205	6.5	12.1
1983	2,735,829	6.2	334,400	7.1	12.2
1984	3,020,259	10.4	371,202	11.0	12.3

Sources: 1970-1984, U.S. Department of Commerce, Bureau of Economic Analysis. (Data for United States represent the total for the 50 states and the District of Columbia.)

**STATE OF CALIFORNIA
COMPARISON OF NATIONAL TO STATE
PER CAPITA PERSONAL INCOME
CALENDAR YEARS 1970-1984**

Year	<u>United States</u>		<u>California</u>		<u>California as a Percent of United States</u>
	<u>Per Capita Personal Income</u>	<u>Percent Change</u>	<u>Per Capita Personal Income</u>	<u>Percent Change</u>	
1970	\$ 3,945		\$ 4,510		114.3
1971	4,167	5.6	4,701	4.2	112.8
1972	4,515	8.4	5,062	7.7	112.1
1973	5,010	11.0	5,496	8.6	109.7
1974	5,448	8.7	6,052	10.1	111.1
1975	5,842	7.2	6,549	8.2	112.1
1976	6,367	9.0	7,155	9.3	112.4
1977	6,984	9.7	7,863	9.9	112.6
1978	7,772	11.3	8,857	12.6	114.0
1979	8,651	11.3	9,951	12.4	115.0
1980	9,494	9.7	11,020	10.7	116.1
1981	10,544	11.1	12,106	9.9	114.8
1982	11,113	5.4	12,642	4.4	113.8
1983	11,690	5.2	13,277	5.0	113.6
1984	12,789	9.4	14,487	9.1	113.3

Sources: 1970-1984, U.S. Department of Commerce, Bureau of Economic Analysis; 1984, California Department of Finance estimates.

**STATE OF CALIFORNIA
CIVILIAN LABOR FORCE FOR
RESIDENT POPULATION AGE 16 AND OVER
CALENDAR YEARS 1973-1984**

<u>Year</u>	<u>Labor Force Trends</u> (In Thousands)			<u>Unemployment Rate</u>	
	<u>Total Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>United States</u>	<u>California</u>
1973	8,910	8,286	624	4.9%	7.0%
1974	9,317	8,638	679	5.6	7.3
1975	9,539	8,598	941	8.5	9.9
1976	9,896	8,990	906	7.7	9.2
1977	10,367	9,513	853	7.1	8.2
1978	10,911	10,137	775	6.1	7.1
1979	11,268	10,566	702	5.8	6.2
1980	11,584	10,794	790	7.1	6.8
1981	11,812	10,938	875	7.6	7.4
1982	12,178	10,967	1,210	9.7	9.9
1983	12,269	11,084	1,185	9.6	9.7
1984	12,503	11,532	972	7.5	7.8

Source: California Employment Development Department.

STATE OF CALIFORNIA
 PERSONS EMPLOYED IN
 PRINCIPAL MANUFACTURING INDUSTRIES
 CALENDAR YEARS 1982 AND 1984
 (IN THOUSANDS)

Industry	1982	1984	Percent Change
Furniture and fixtures	43.2	59.4	37.5
Lumber and wood products	46.3	55.2	19.2
Electric and electronic equipment	351.2	399.9	13.9
Textile mill products	12.4	14.1	13.7
Rubber and miscellaneous plastic products	61.2	67.8	10.8
Printing and publishing	124.5	136.8	9.9
Apparel	102.4	109.0	6.4
Fabricated metal products	137.6	145.0	5.4
Instruments and related products	102.4	107.5	5.0
Paper and allied products	37.3	38.9	4.3
Transportation equipment	263.3	274.0	4.1
Machinery, except electrical	227.6	235.7	3.6
Stone, clay, and glass products	50.4	51.8	2.8
Miscellaneous	38.4	38.0	(1.0)
Chemicals and allied products	64.5	63.8	(1.1)
Petroleum and coal products	31.7	30.4	(4.1)
Food and kindred products	182.5	174.9	(4.2)
Primary metal products	47.6	42.4	(10.9)
Leather and leather products	10.5	8.2	(21.9)
Total	<u>1,935.0</u>	<u>2,052.8</u>	6.1

Sources: U.S. Department of Commerce, Bureau of the Census; California
 Employment Development Department