State of California

Internal Control and Compliance Audit Report
for the Fiscal Year Ended June 30, 2022

March 2024

REPORT 2022-001.1

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Grant Parks *State Auditor*

Mike Tilden *Chief Deputy*

March 15, 2024
2022-001.1

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Government Code section 8543 et seq., the California State Auditor's Office presents its audit report concerning our review of the State of California's internal controls and compliance with state regulations for the fiscal year ended June 30, 2022.

This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State's internal control and compliance based on our audit of the State's basic financial statements. We identified nine deficiencies in internal control over financial reporting that we consider to be material weaknesses and six other deficiencies that we consider to be significant. Deficiencies in the State's internal control system could adversely affect its ability to provide accurate and timely financial information.

Respectfully submitted,

Linus Li

LINUS LI, CPA
Deputy State Auditor

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Grant Parks *State Auditor*

Mike Tilden *Chief Deputy*

Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Independent Auditor's Report

The Governor and the Legislature of the State of California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California as of and for the year ended June 30, 2022, and the related notes to the financial statements, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated March 8, 2024. Our report qualifies an opinion on the Federal Fund and Governmental Activities for the following reasons.

The Employment Development Department had inadequate internal control over its financial reporting for federally funded unemployment insurance (UI) benefits, including not properly estimating the total population of ineligible payments. As a result, the department was unable to provide complete and accurate information for certain accounts within the federally funded portion of its UI program. We were therefore unable to obtain sufficient and appropriate audit evidence to conclude that the department's balances representing 100 percent of Other Liabilities, 11 percent of Intergovernmental Revenues, and 12 percent of Health and Human Services Expenditures within the Federal Fund are free from material misstatement.

The issues pertaining to the Federal Fund also affect the Governmental Activities. Therefore, we were unable to obtain sufficient and appropriate audit evidence about the Federal Fund balances that represent 99 percent of Other Current Liabilities, 12 percent of Health and Human Services Revenues, and 8 percent of Health and Human Services Expenses within Governmental Activities.

Our report includes a reference to other auditors who audited the financial statements of the following, as described in our report on the State of California's financial statements:

Government-wide Financial Statements

- Certain governmental funds that, in the aggregate, represent 1 percent of the assets and deferred outflows, and less than 1 percent of the revenues of the governmental activities.
- Certain enterprise funds that, in the aggregate, represent 82 percent of the assets and deferred outflows, and 59 percent of the revenues of the business-type activities.
- The University of California and the California Housing Finance Agency that represents 92 percent of the assets and deferred outflows, and 95 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power, Water Resources, State Lottery, and California State University.

- The Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control Revolving, the Safe Drinking Water State Revolving, and the 1943 Veterans Farm and Home Building funds, that represent 87 percent of the assets and deferred outflows, and less than 1 percent of the additions, revenues and other financing sources of the aggregate remaining fund information.

- The discretely presented component units noted above.

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the Golden State Tobacco Securitization Corporation, the Public Works Board Building Construction Fund, the State Lottery Fund, and the Campus Foundations of the University of California, which represent 13 percent of the university's total assets and deferred outflows of resources and 5 percent of its revenues, were not audited in accordance with *Government Auditing Standards*, and accordingly, this report does not include reporting on internal control over financial reporting or compliance and other matters associated with the Golden State Tobacco Securitization Corporation, the Public Works Board Building Construction Fund, the State Lottery Fund, or the Campus Foundations of the University of California.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the State of California's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of California's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of California's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as items 2022-1 through 2022-9 to be material weaknesses.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as items 2022-10 through 2022-15 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of California's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

State of California's Response to Findings

Government Auditing Standards require the auditor to perform limited procedures on the State of California's response to the findings identified in our audit and described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. The State of California's responses were not subjected to the other auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the State of California's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State of California's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

CALIFORNIA STATE AUDITOR

Linus Li

LINUS LI, CPA
Deputy State Auditor

Sacramento, California

March 8, 2024

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2022

Summary of Auditor's Results

Financial Statements

Type of auditor's report issued	Qualified opinions for Governmental Activities and Federal Fund, and Unmodified opinions for all other opinion units
Internal control over financial reporting:	
Material weaknesses identified?	Yes
Significant deficiencies identified that are not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	No

Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements

EMPLOYMENT DEVELOPMENT DEPARTMENT

Reference Number: 2022-1

Condition:

Similar to the past two fiscal years, the Employment Development Department (EDD) did not properly estimate the total population of ineligible unemployment insurance (UI) benefits paid using pandemic program funding from the federal government. As a result, EDD was unable to provide accurate and complete financial information for fiscal year 2021–22 for the federally funded portion of its UI program. The lack of appropriate estimates resulted in possible material misstatements in EDD's year-end financial reports and led to the modified opinions we expressed on the Federal Fund and Governmental Activities within the State's Annual Comprehensive Financial Report (ACFR).

As noted in our prior year's internal control report, EDD's approach for preventing ineligible payments had significant weaknesses during fiscal years 2019–20 and 2020–21, including paying claimants with suspicious addresses or unconfirmed identities. During fiscal year 2021–22, certain weaknesses persisted, including a 10-month delay by EDD in implementing a U.S. Department of Labor (DOL) requirement to verify the eligibility of claims from self-employed individuals.

EDD prepared an estimate of total ineligible payments as of June 30, 2022, but errors in its process have resulted in this estimate being unreliable. Specifically, EDD provided an initial estimate totaling $26 billion in paid ineligible benefits. However, this estimate relied upon incomplete information because EDD's methodology for developing the estimate inappropriately excluded certain payments that it confirmed to be ineligible. We also found that this estimate omitted a sizable population of payments to claimants who did not provide the required documentation substantiating their self-employment or employment, or their earnings. In response, EDD provided an additional estimate of $29 billion to account for these paid benefits, increasing its overall estimate to $55 billion. However, EDD was unable to provide sufficient information substantiating this additional estimate. Because of these issues, there are possible material misstatements in the beginning balances, liabilities, revenues, and expenditures in the financial reports of the Federal Fund and Governmental Activities.

In December 2023, DOL issued *Unemployment Insurance Program Letter 05-24*, raising the possibility that California's existing statutes of limitations could result in the waiving of repayment of these ineligible benefits. In February 2024, EDD submitted a letter to DOL requesting federal approval to forgive repayment. EDD has yet to receive this approval and therefore continues to report its obligation to repay the federal government.

Lastly, in the prior fiscal year, we had reported that EDD did not complete its bank reconciliations or reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. Although it has made progress in this area, EDD did not complete these reconciliations within the required 30 days during fiscal year 2021–22. Further, EDD's reconciliation of the UI program to the State Controller's records was missing certain information needed to reconcile. After we raised this issue with EDD, it corrected the reconciliation.

Criteria:

Government Code section 12461 requires the State Controller to issue an ACFR that is prepared in accordance with generally accepted accounting principles (GAAP).

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that the financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues should be recognized in the accounting period in which they become available and measurable. Expenditures should be recognized in the accounting period in which the fund liability is incurred.

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that federal funding should only be recognized as receivables and revenue after all applicable eligibility requirements are met.

Recommendations:

To prevent misstatements from recurring in its financial reports, EDD should take the following actions:

- Revisit its methodology for estimating ineligible payments to ensure that it includes ineligible claims and excludes claims confirmed to be eligible. EDD should implement multiple levels of review during each step of the estimation process.

- Provide guidance and training to both program and accounting staff on the requirements of GAAP.

Department's View and Corrective Actions:

EDD partially agreed with our recommendation for it to revisit its methodology for estimating ineligible payments. EDD stated that it had leveraged the acquired knowledge from the past two fiscal years and proactively established and validated this methodology in preparation for fiscal year 2021–22. However, EDD then claimed that the State Auditor's Office requested a change from this existing methodology in order to address all ineligible benefit payments.

EDD agreed with our recommendation to implement multiple levels of review during each step of the estimation process. EDD also stated that although it has developed mechanisms for validating the ineligible payments estimate, it will continue working towards strengthening its review process. In addition, EDD agreed with our recommendation to provide guidance and training to program and accounting staff on the requirements of GAAP.

Comment:

To provide clarity and perspective, we are commenting on EDD's response to our finding.

We are concerned about EDD's characterization of its approach to estimating ineligible payments. EDD's statement that our office requested a change in its methodology is inaccurate and implies that we are responsible for developing its methodology. The department is responsible for its methods, significant assumptions, and data used when preparing the accounting estimates included within its financial reports, so that it can ensure they are complete and appropriate. In addition, for the past several years, we have routinely informed EDD about the requirements of GAAP, which have remained the same since the start of the pandemic. It was not until the current year that EDD decided to broaden its methodology supporting its estimate to better align with the requirements that we informed it about. Nevertheless, as addressed in our finding, we still determined that EDD's estimate excluded a sizeable population of ineligible payments. Consequently, EDD will need to make significant improvements to its methodologies for developing estimates in order to comply with the requirements of GAAP.

DEPARTMENT OF FINANCIAL INFORMATION SYSTEM FOR CALIFORNIA (FI$Cal)

Reference Number: 2022-2

Condition:

We identified pervasive findings in the overall information technology (IT) general controls and application controls environment of the Financial Information System for California (FI$Cal). Details of these findings are being withheld pursuant to Government Code section 8592.45, which prohibits disclosure of certain information related to the FI$Cal IT infrastructure. Accordingly, and consistent with applicable auditing standards, we decided not to publish these details. Nineteen (19) out of forty-nine (49) control deficiencies have Plans of Action and Milestones (POAMs), which the Department of FISCal (department) had not remediated as of the end of the audit period. Further, sufficient compensating controls were not in place to reduce the impact of these findings on the IT general and application controls environment.

The primary cause of these issues was that the department's control processes lacked the necessary level of maturity to consistently achieve its objectives. This was due to inadequate documentation, gaps in established processes, or a lack of monitoring and feedback mechanisms to identify and implement process improvements in a timely manner.

The deficiencies result in pervasive risks at the entity and system-level to automated controls and configurations of the FI$Cal system, which impact the ability to rely on FI$Cal data used for financial reporting. Deficiencies in IT general controls could compromise the reliability and integrity of financial data and increases the risk of misstatements in the financial reports.

Criteria:

Financial Audit Manual (FAM) 240 states in relevant part:

"(.13) IS [information system] controls consist of those internal controls that depend on information system processing and include general controls, application controls, and user controls. Information system general controls (implemented at the entity-wide, system, and application levels) are the structure, policies and procedures that apply to all or a large segment of an entity's information systems. General controls help ensure the proper operation of information systems by creating the environment for effective operation of application controls. General controls include security management, access (logical and physical), configuration management, segregation of duties, and contingency planning controls. An effective information system general control environment:

- provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls (security management);

- limits or detects access to computer resources, such as data, programs, equipment, and facilities, thereby protecting them against unauthorized modification, loss, or disclosure (logical and physical access);

- prevents unauthorized changes to information system resources, such as software programs and hardware configurations, and provides reasonable assurance that systems are configured and operating securely and as intended (configuration management);

- includes policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations (segregation of duties); and

- protects critical and sensitive data, and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur (contingency planning).

- (.14) Application controls, sometimes referred to as business process controls, are those controls incorporated directly into information systems to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. An effective application control environment includes:

- general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);

- controls over transaction data input, processing, and output as well as master data maintenance;

- interface controls over the timely, accurate, and complete processing of information between information systems; and

- controls over the data management systems."

State Administrative Manual (SAM) section 5300.5 states:

"California has adopted the National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53 as minimum information security control requirements to support implementation and compliance with the Federal Information Processing Standards (FIPS). Each state entity shall use the FIPS and NIST SP 800-53 in the planning, development, implementation, and maintenance of their information security programs.

The CISO has also adopted additional standards and procedures to address more specific requirements or needs unique to California. These additional standards are referenced in the applicable policy section and maintained in the Statewide Information Management Manual (SIMM). Entities shall ensure their security control selections and tailoring, at a minimum, comply with the State-defined Security Parameters for NIST SP 800-53 (SIMM 5300-A) and the prioritization of their information security program development and implementation align with the Foundational Framework for Information Security (SIMM 5300-B)."

SAM section 5305 states:

"Each state entity is responsible for establishing an information security program. The program shall include planning, oversight, and coordination of its information security program activities to effectively manage risk, provide for the protection of information assets, and prevent illegal activity, fraud, waste, and abuse in the use of information assets.

Each state entity shall:

1. Align the information security program, its activities, and staff with the requirements of this Chapter;

2. Establish a governance body to direct the development of state entity specific information security plans, policies, standards, and other authoritative documents;

3. Oversee the creation, maintenance, and enforcement of established information security policies, standards, procedures, and guidelines;

4. Ensure the state entity's security policies and procedures are fully documented and state entity staff is aware of, has agreed to comply with, and understands the consequences of failure to comply with policies and procedures;

5. Identify and integrate or align information security goals and objectives to the state entity's strategic and tactical plans;

6. Develop and track information security and privacy risk key performance indicators;

7. Develop and disseminate security and privacy metrics and risk information to state entity executives and other managers for decision making purposes; and

8. Coordinate state entity security efforts with local government entities and other branches of government as applicable."

Recommendations:

The department should take the following actions:

- Perform and document a comprehensive risk assessment to re-evaluate FI$Cal governance in accordance with SAM, NIST SP 800-53, FIPS, financial reporting, and other state and federal requirements.

- Update the department's FI$Cal System Security Plan (SSP), which accurately documents critical policies and procedures associated with the execution and monitoring of controls.

- Continue to update policies and procedures, which demonstrate management's controls in place to monitor and prevent risk as designed within the SSP.

- Generate a project plan for remediation of findings, enhancing the control environment, which reflects the strategic goals identified as part of the comprehensive risk assessment.
- Incorporate a process to make consistent progress against open POAMs and to actively pursue remediation of findings that incorporates post-implementation monitoring.
- Review department control activities as identified in the SSP and validate that they are functioning properly.
- Conduct information, communication, and monitoring activities to promote awareness of updated processes.

Department's View and Corrective Actions:

The department agrees with the auditor's comments and is committed to addressing any remaining findings in a timely manner. The security of the system is our highest priority and we greatly value State Auditor's Office (State Auditor) feedback and take the concerns stated in the report seriously.

To safeguard the system and data, the department is vigilant against external threats, including emerging threats and operational security, and has made consistent progress in closing the POAMs and improving our security posture.

The department's emphasis on both external threats and internal control process improvements continued during the State Auditor's audit for fiscal year 2021–22, which concluded in January 2024. We are happy to report the department has made several improvements to our risk assessment and governance processes, internal controls, policies, procedures, and documentation review/update processes to address the findings and further improve our maturity in internal controls and compliance. The department will continue to advance the maturity of our internal controls to fully meet the compliance requirements. We look forward to continuing our collaboration with the State Auditor to ensure the security and highest standards of our FI$Cal system and the financial data for which we are entrusted.

STATE CONTROLLER'S OFFICE

Reference Number: 2022-3

Condition:

For fiscal year 2020–21, we reported that the State Controller's Office (State Controller) did not sufficiently detect and prevent errors that could have caused material misstatements in the State's Annual Comprehensive Financial Report (ACFR). Specifically, the State Controller posted numerous inaccurate adjusting entries to the State's accounting records, which indicated that it had an insufficient internal review process to identify and prevent material errors. During fiscal year 2021–22, we again found that the State Controller had posted several inaccurate adjusting entries that misstated the account balances of several opinion units. The frequency and pervasiveness of these errors indicates that the State Controller has not effectively implemented our recommendations from the prior year. Until the State Controller fully addresses these recommendations, it will continue to be unable to ensure the accuracy and completeness of the amounts it reports for inclusion in the State's ACFR.

Criteria:

Government Code section 12460 requires the State Controller to annually issue two financial reports that each adhere to different accounting principles. The first report—the State's Budgetary/Legal Basis Annual Report—conforms to the Governor's Budget and follows budgetary basis principles. That report is used to develop the second report—the ACFR—that conforms to generally accepted accounting principles (GAAP). In instances when the budgetary basis rules differ from those of GAAP, the State Controller or applicable department must prepare accounting entries to adjust the financial statements to comply with GAAP. For instance, if the budgetary basis rules require the recognition of revenues or expenditures on a cash basis, adjusting entries are needed to accrue certain transactions under GAAP. To prepare its financial report, the State Controller annually requests departments to submit GAAP-adjusting entries for the funds they manage. In certain instances, the State Controller prepares additional adjusting entries to ensure that the department's entries are in compliance with GAAP.

The State Controller has established desk procedures to guide its staff in preparing the ACFR. The State Controller is also responsible for designing, implementing, and maintaining processes relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error.

Recommendations:

To ensure that the ACFR is properly presented at fiscal year-end, the State Controller should take the following actions:

- Develop and implement an effective formal process for reviewing and approving entries before posting them into its GAAP accounting system.

- Develop and implement an effective process to review financial statements after entries are posted to ensure the accuracy of account balances.
- Develop and implement an effective process to evaluate its desk procedures and update them as necessary.
- Develop and implement proper internal controls to thoroughly evaluate the effectiveness of any newly created procedures.
- Provide guidance and training to staff to ensure that they understand key accounting concepts and the purpose of the tasks they perform.

Department's View and Corrective Actions:

The State Controller believes that it has taken extensive measures to strengthen internal controls, update business processes, refine departmental communications, and increase staffing resources for fiscal year 2021–22. The State Controller is committed to continuously improving quality assurance and internal controls and will continue to evaluate business procedures and staff training to ensure trust and confidence in the reporting process. The State Controller recognizes that accurate and timely financial reporting is critical to support the State's overall financial objectives and will continue to prioritize the publication of an accurate and timely ACFR.

CALIFORNIA DEPARTMENT OF EDUCATION

Reference Number: 2022-4

Condition:

The California Department of Education (Education) understated its expenditures and related revenues in the Federal Fund by $952 million, which was primarily related to a federal grant made available under the Coronavirus Response and Relief Supplemental Appropriations Act of 2021. Specifically, Education made payments during fiscal year 2021–22 to various local educational agencies (LEAs) participating in the Elementary and Secondary School Emergency Relief program. This program provides LEAs with emergency relief funding to address the effects of COVID-19 on elementary and secondary schools. In compliance with federal requirements, LEAs incur actual costs allowable under the program, which they report to Education. When preparing its financial reports, Education reported only the fiscal year 2021–22 payments and did not report its obligation to reimburse the LEAs for the additional costs they had incurred by fiscal year-end, as is required by generally accepted accounting principles (GAAP).

In the prior year, we reported that Education overstated its expenditures and related revenues in the Federal Fund for this program by $16 billion. We recommended that Education develop written procedures to ensure that it prepares and adequately reviews entries included in its financial reports to ensure compliance with GAAP. Although Education has since revised its procedures, these new procedures do not comply with GAAP. We also recommended that staff preparing the financial reports receive proper guidance and training on GAAP requirements. We found that Education did not implement this recommendation. Until Education addresses our recommendations, it will continue to be unable to ensure the accuracy and completeness of its year-end financial reports.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards Section N50 states that for nonexchange transactions, recipients should recognize revenues, and providers should recognize expenditures, when all applicable eligibility requirements are met. This includes incurring an allowable cost under an expenditure-driven grant.

Recommendations:

To ensure that its financial reports are not materially misstated in the future, Education should do the following:

- Revise its written procedures to ensure that it prepares and adequately reviews entries to report expenditures and related revenues in accordance with GAAP.

- Ensure that the staff preparing and reviewing financial reports receive adequate guidance and training in GAAP requirements.

Department's View and Corrective Actions:

Education agrees with the finding and recommendations. Education is committed to strengthening its existing processes by updating its written procedures for year-end accruals, which include adequately reviewing journal entries to ensure that the reporting of expenditures and related revenues are in accordance with GAAP. Specifically, the procedures will clearly define the steps required to prepare and review expenditure entries for reporting; identify and define the roles and responsibilities of each team member involved in the process; and identify the specific GAAP standards, such as GASB 33, that apply to Education's expenditure entry and reporting process. Additionally, Education staff will annually review GAAP instructions that the State Controller's Office posted on its website to ensure that Education's procedures remain aligned and up to date with them. Education will also strengthen its existing processes by including GAAP training in its year-end work plan, thus ensuring staff responsible for preparing and reviewing financial reports are appropriately trained and fully understand GAAP requirements.

DEPARTMENT OF FINANCE

Reference Number: 2022-5

Condition:

For fiscal year 2020–21, we reported that the Department of Finance (Finance) did not properly recognize expenditures and related revenues pertaining to its spending of revenue replacement funds provided by the federal government under the American Rescue Plan Act of 2021 (ARPA). This error caused misstatements to the financial reports of the Federal Fund and General Fund that required correction. For fiscal year 2021–22, we have again found that Finance did not properly report its spending of revenue replacement funds. As a result, Finance understated its expenditures and revenues in the Federal Fund and overstated its expenditures in the General Fund by $5.6 billion.

ARPA granted funds to compensate for the loss of revenue resulting from the COVID-19 public health emergency and allowed the State to use those funds to provide government services. Finance spent additional lost revenue monies during fiscal year 2021–22 on such costs as payroll and capital asset related maintenance and had not yet transferred a portion of the prior year's reimbursement to the General Fund. However, Finance did not accrue this additional spending or re-accrue the pending prior year reimbursement in its financial reports. When we brought this issue to Finance's attention, it stated that since the executive orders authorizing these transfers were dated after fiscal year-end, it did not report this activity in the financial reports. Finance subsequently revisited its accruals and made the necessary correcting entries.

Until Finance fully addresses our recommendations, it will continue to be unable to ensure the accuracy and completeness of the amounts it reports for inclusion in the State's Annual Comprehensive Financial Report (ACFR).

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that for nonexchange transactions, recipients should recognize revenues and providers should recognize expenditures when all applicable eligibility requirements are met. This accounting recognition includes incurring an allowable cost under an expenditure-driven grant. Cash and other assets provided in advance should be reported as liabilities by recipients until allowable costs have been incurred and other eligibility requirements have been met.

Recommendations:

To ensure that its financial reports are properly presented and comply with generally accepted accounting principles (GAAP) at fiscal year-end, Finance should do the following:

- Provide guidance and training to its staff on the requirements of GAAP including the reporting of non-exchange transactions.
- Seek additional guidance from the Governmental Accounting Standards Board, as needed.

Department's View and Corrective Actions:

Finance acknowledges that the initial accounting entries and reports were revised after making a final determination on how to allocate ARPA funds and completing a final loss revenue calculation. The revised entries and reports were incorporated into the State's ACFR. Finance has implemented additional controls to ensure that subsequent events are identified earlier in the reporting cycle.

Comment:

To provide clarity and perspective, we are commenting on Finance's response to our finding.

Finance's response does not align with the evidence it provided to us during the audit. Moreover, the entries needed to correct the financial statements were not dependent on the final determination that Finance describes. As stated in our finding above, Finance did not accrue the additional spending or re-accrue the pending prior-year reimbursement as a result of the timing of the transfers to the General Fund. Accordingly, we stand by our recommendations.

FRANCHISE TAX BOARD

Reference Number: 2022-6

Condition:

For the past two fiscal years, we have reported that the Franchise Tax Board (FTB) did not properly accrue corporate income tax revenues or personal income tax revenues, which caused material misstatements to the financial reports of the General Fund. Furthermore, in the prior year, we reported that FTB did not properly report expenditures related to a grant program, which also caused material misstatements to the financial reports of the General Fund. FTB subsequently corrected these errors because of their magnitude. For fiscal year 2021–22, we have similarly found that FTB did not properly report corporate income tax revenues, personal income tax revenues, or expenditures related to another new grant program. Individually, these errors caused material misstatements to the General Fund that required FTB to correct them.

Specifically, similar to fiscal year 2019–20, FTB did not properly address extended tax deadlines affecting both personal income tax and corporate tax revenues. Because of severe winter storms throughout much of California in late 2022 and early 2023, FTB had extended various payment and filing deadlines within calendar year 2023 to November 16, 2023. However, FTB did not initially account for these extensions in its accrual methodologies, and therefore it submitted inaccurate information to the State Controller's Office (State Controller) for inclusion in the State's Annual Comprehensive Financial Report (ACFR). FTB later updated its methodologies to account for the extensions. However, many of these updates did not comply with generally accepted accounting principles (GAAP). After it made numerous attempts to update its accruals, the extensions ultimately accounted for an additional $4 billion in personal income tax revenues and $3.4 billion in refunds, as well as an additional $1.2 billion in corporate income tax revenues and $1.68 billion in refunds for fiscal year 2021–22.

In addition, FTB overstated corporate tax revenues related to pass-through-entity elective taxes by $2.7 billion. In fiscal year 2020–21, FTB had materially understated these revenues. Starting with tax year 2021, certain pass-through entities, such as partnerships, are permitted to be taxed at the entity level. Qualified taxpayers are then eligible to claim nonrefundable credits for the amount paid on their personal income tax returns. For tax year 2021, pass-through entities were required to pay this elective tax by their final tax return deadline. However, starting with tax year 2022, pass-through entities are required to pay this elective tax in two installments, with the first installment due by June 15 of the respective tax year, and the second installment due by the final tax return deadline. FTB did not update its accrual methodology for this change. As a result, FTB overstated corporate tax revenues because it did not account for the fact that much of its earned pass-through entity elective tax revenue for fiscal year 2021–22 had already been collected on a cash basis as of June 30, 2022.

Similar to fiscal year 2020–21, FTB understated expenditures by $9.1 billion related to a new grant program. In June 2022, the Legislature passed the Better for Families Act, thereby requiring the State Controller to issue one-time payments to qualified recipients for the purpose of providing financial relief for Californians who may have been adversely affected by increased costs for goods, the effects of the COVID-19 pandemic, and other economic pressures. FTB did not accrue the expenditures related to these payments made during fiscal year 2022–23. Finally, similar to our finding in the prior fiscal year, FTB made a number of mechanical errors within its accrual calculations related to the input data it used and in the logical application of its established accrual methodologies.

These errors occurred because FTB has not implemented our prior recommendations. In particular, program staff preparing the accruals and the accounting department that is responsible for certain financial reporting do not have a sufficient understanding of GAAP governing non-exchange transactions. Until FTB fully addresses our recommendations, it will continue to be unable to ensure the accuracy and completeness of the amounts it reports for inclusion in the State's ACFR.

Criteria:

Government Code section 12461 requires the State Controller to issue an ACFR that is prepared in accordance with GAAP.

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting, which requires revenues to be reported when they become available and measurable.

Codification of Governmental Accounting and Financial Reporting Standards section 2200 states that revenue that does not meet the "availability" criterion of the modified accrual basis of accounting is reported as a deferred inflow of resources in governmental funds.

Codification of Governmental Accounting and Financial Reporting Standards section N50: Nonexchange Transactions paragraph 113 states that governments should recognize revenues from derived tax revenue transactions, net of estimated refunds. Paragraph 118 states that government providers of resources should recognize liabilities (or a decrease in assets) and expenses from government-mandated or voluntary nonexchange transactions when all applicable eligibility requirements, including time requirements, are met.

Recommendations:

To ensure that its financial statements are properly presented at fiscal year-end and comply with GAAP, FTB should do the following:

- Review and update its existing accrual methodologies as changes are made to the tax law or other relevant legislation, to ensure that they are up to date and comply with current GAAP requirements.

- Institute and document a formal review process of the accrual calculations to ensure that they follow the established methodologies and are free from errors. Given the material nature of these accruals and the number of steps involved, FTB should conduct a minimum of two levels of supervisory review. In addition, given that these accruals are prepared multiple times per year, this review should occur each time the accruals are submitted to the State Controller.

- Provide guidance and training to both program and accounting staff on the requirements of GAAP.

- Improve the internal communications between program and accounting staff, so that both groups are engaged in the development of the accruals, have a thorough understanding of the accruals, and are aware of their respective responsibilities.

Department's View and Corrective Actions:

FTB agrees with the finding and recommendations. FTB stated that it plans to enhance and document the review process over the accrual calculations to ensure that they follow the established methodology and are free from errors. FTB also plans to provide additional guidance and training on the requirements of GAAP to its program and accounting staff. Finally, FTB stated that its economic and statistical research bureau would continue to collaborate with its accounting section to ensure that both groups have a thorough understanding of the accruals and are aware of their respective responsibilities.

CALIFORNIA DEPARTMENT OF PUBLIC HEALTH

Reference Number: 2022-7

Condition:

For fiscal year 2020–21, we reported that the California Department of Public Health (CDPH) had understated its year-end accruals in the General Fund. During fiscal year 2021–22, we found that CDPH has again understated its year-end accruals because it did not yet implement our prior year's recommendation. As a result, the financial statements CDPH submitted to the State Controller's Office (State Controller) had misstatements that required correction. These errors occurred primarily because CDPH's existing policies for developing expenditure accruals instruct staff not to include invoices associated with existing encumbrances in its determination, because it assumes that it has already accrued these invoices when reporting on a budgetary basis. However, encumbrances do not represent actual liabilities under generally accepted accounting principles (GAAP). Because CDPH did not accurately record this accrual to reduce its encumbrance balance, the State Controller unnecessarily eliminated the encumbered liabilities reported by CDPH when compiling the State's Annual Comprehensive Financial Report (ACFR). As a result, CDPH erroneously understated its accounts payable and expenditures in the General Fund by $479 million.

When we brought this issue to CDPH's attention, it reviewed its year-end accruals and made the necessary correcting entries. However, until CDPH fully addresses our recommendations, it will continue to report erroneous amounts to the State Controller for inclusion in the State's ACFR.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. This measurement focus and basis of accounting require expenditures to be reported when related liabilities have been incurred, regardless of when related cash is disbursed.

Codification of Governmental Accounting and Financial Reporting Standards section 1700 states that encumbrances outstanding at year-end represent the estimated amount of expenditures ultimately to result if unperformed contracts in process at year-end are completed. Encumbrances do not constitute expenditures or liabilities.

Recommendations:

To ensure that its financial statements are properly presented at fiscal year-end, CDPH should do the following:

- Develop GAAP-compliant policies and procedures on how to prepare year-end accruals.
- Train its staff on how to follow such accrual policies and procedures.

Department's View and Corrective Actions:

CDPH agreed with our finding and recommendations. It stated that it has made updates to its accrual procedures to ensure the reporting of liabilities in accordance with GAAP. It also stated that it is currently revising its training to notify staff of this change.

CALIFORNIA STUDENT AID COMMISSION

Reference Number: 2022-8

Condition:

The California Student Aid Commission (CSAC) overstated its fiscal year 2021–22 expenditures in the General Fund by $762.4 million. This misstatement was primarily related to CSAC's Financial Aid Grant Program. When calculating the amount owed at June 30, 2022, CSAC mistakenly accrued the program's total unspent budget authority rather than accruing the program expenditures it had incurred but not yet paid at fiscal year-end. This error occurred because CSAC lacked procedures for its fiscal year-end accrual process, and staff preparing the accrual did not sufficiently understand generally accepted accounting principles (GAAP) governing expenditure accruals. When we brought this issue to CSAC's attention, it made correcting entries to appropriately reduce its expenditures.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. This measurement focus and basis of accounting requires expenditures to be reported when related liabilities have been incurred, regardless of when the cash is disbursed.

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that for nonexchange transactions, recipients should recognize revenues and providers should recognize expenditures when all applicable eligibility requirements are met.

Government Code section 12460 requires the State Controller to issue an Annual Comprehensive Financial Report (ACFR) in accordance with GAAP. In its year-end financial reports manuals, the State Controller provides guidance to departments on the preparation of their year-end financial statements, which form the basis of the ACFR. Among other things, the guidance directs departments to submit expenditure accruals for the funds they manage.

Recommendations:

To ensure that it properly reports expenditures, CSAC should do the following:

- Develop policies and procedures on how to prepare GAAP-compliant year-end accruals.

- Train its staff on how to follow such policies and procedures.

Department's View and Corrective Actions:

CSAC agreed with our finding and recommendations. It stated that efforts are underway to implement our recommendations for subsequent fiscal years.

MULTIPLE DEPARTMENTS PREPARING YEAR-END ACCRUALS

Reference Number: 2022-9

Condition:

We identified five departments in fiscal year 2021–22 that lacked department-specific policies related to year-end accruals or that had policies that do not comply with generally accepted accounting principles (GAAP). Because departments operate programs that vary in the timing and consistency of expenditures incurred, it is critical for them to have policies and procedures that are tailored to their situations in order to guide staff in the correct preparation of year-end accruals. For example, the California Energy Commission (Energy Commission) operates a program where it contracts with a non-profit to implement electric vehicle charger incentive projects. The non-profit bills the Energy Commission monthly, providing a consistent and predictable cycle of expenditures. On the other hand, the State Water Resources Control Board (SWRCB) operates a program where it contracts with local governments for the construction of groundwater treatment facilities. Contractors bill SWRCB as they incur eligible project costs, which may result in large and variable expenditures. For certain departments we reviewed, failure to accrue expenditures properly creates a significant risk of material misstatements for the State's financial statements. For example, departments operating programs related to the environment and natural resources had $11 billion in outstanding encumbered[1] agreements at June 30, 2022. Although we did not identify a material misstatement for fiscal year 2021–22 for these departments, the value of their agreements represents a pool of significant potential expenditures that may need accrual in the future.

For example, we inquired of the Energy Commission about its year-end accrual process, because it manages programs that had nearly $1 billion in encumbrances at June 30, 2022. When we asked about policies and procedures for accruing expenditures, the Energy Commission stated that it relies on guidance published by the Department of Finance (Finance) and did not provide us with any other policies and procedures. Finance publishes general guidance for departments to follow regarding the year-end closing process. The guidance instructs departments to review encumbrances at the end of the fiscal year and helps explain how to post entries to the State's accounting system. However, because the guidance applies to all departments, it does not provide the specificity needed to ensure that individual departments make proper accruals according to the unique requirements of their programs.

Four other departments, each with encumbrances exceeding $800 million, had procedures that do not comply with accounting standards or do not contain sufficient detail to ensure the accurate preparation of year-end accruals. Specifically, three departments' policies direct staff to cut off their review of invoices prematurely. Thus, these policies do not allow a reasonable amount of time to pass after the end of the fiscal year for staff to review subsequent invoices that may identify activity occurring prior to June 30. For example, the California Air Resources Board (Air Resources) has policies and procedures for accruing expenditures that inaccurately

1 Encumbrances represent agreements the State has entered into that may need to be accrued as expenditures if goods or services have been received by the end of the fiscal year.

direct staff to limit such accruals to invoices received by the end of the fiscal year. Accounting standards and state accounting policies require departments to accrue expenditures depending on when vendors provide goods or services and meet other agreement requirements—such as grant terms—and not simply based on the timing of when a department receives an invoice. Similarly, the Department of Parks and Recreation (State Parks) developed procedures pertaining to expenditure accruals, but those procedures focus primarily on its responsibilities relating to budgetary-basis reporting. The procedures also direct State Parks to cut off its review of invoices in early July. In addition, SWRCB did not accrue some invoices entered into its accounting system after year-end for goods or services provided by the end of fiscal year 2021–22, because it prematurely completed its review in early July 2022. When we brought this issue to SWRCB's attention, it made an adjusting entry of $42 million to correct the misstatement.

Lastly, we found another department within the Federal Fund that has an accrual policy that does not comply with GAAP. Specifically, the Department of Housing and Community Development (HCD) was awarded $1.2 billion in federal funding under the American Rescue Plan Act of 2021 for its Home Key Program. Under this expenditure-driven grant, HCD disburses monies to local governments prior to these grantees incurring eligible costs. Therefore, HCD must report an asset in the form of an advance to account for any disbursements in excess of costs incurred. Currently, HCD's policy is limited to accruing invoices received in the next fiscal year but does not address the proper reporting of assets pertaining to programs that advance monies to grantees. When we brought this issue to HCD's attention, it made an adjusting entry of $271 million to correct the misstatement.

Although these departments had policies to address year-end accruals, the policies were limited and did not sufficiently address the departments' responsibilities related to preparation of the State's financial statements and compliance with GAAP. Based on our review, these departments did not have sufficient knowledge of GAAP requirements to develop adequate policies. If the departments do not accrue expenditures and account for advances properly, there exists a significant risk of material misstatements in the State's financial statements.

Criteria:

State Administrative Manual sections 8291 and 8340 require departments, as part of an effective system of internal controls, to record accruals accurately and timely.

Codification of Governmental Accounting and Financial Reporting Standards Section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. This measurement focus and basis of accounting require expenditures to be reported when related liabilities have been incurred, regardless of when related cash is disbursed.

Codification of Governmental Accounting and Financial Reporting Standards Section N50 states that for nonexchange transactions, recipients should recognize revenues, and providers should recognize expenditures, when all applicable eligibility requirements are met. This may include incurring an allowable cost under an expenditure-driven grant. Cash and other assets provided in advance should be reported as advances (assets) by providers and as liabilities by recipients until allowable costs have been incurred and any other eligibility requirements have been met.

Recommendations:

To ensure the proper reporting of expenditures, departments should do the following:

- Develop GAAP-compliant policies and procedures on how to prepare year-end accruals.

- Train their staff on how to follow such accrual policies and procedures.

Departments' Views and Corrective Actions:

State Parks, Energy Commission, and SWRCB agreed with our recommendations and indicated they would implement them. Air Resources also agreed with our recommendations but stated that it believes its staff have knowledge and awareness of GAAP requirements.

In addition, HCD agrees with the finding and recommendations, and it plans to enhance its year-end accrual processes and procedures. Once completed, HCD plans to train staff on the updates to those processes and procedures.

CALIFORNIA DEPARTMENT OF FORESTRY AND FIRE PROTECTION

Reference Number: 2022-10

Condition:

In prior fiscal years, we reported that the California Department of Forestry and Fire Protection (CalFire) did not reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2021–22, CalFire continued to complete its reconciliations late. Moreover, the department completed only one reconciliation, covering the entire year, instead of conducting required monthly reconciliations. Consequently, the reconciliations for some months were extremely late—more than 400 days late for July and August 2021. These delayed reconciliations also contributed to CalFire's delay in submitting its year-end financial reports to the State Controller. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

CalFire informed us that it was not able to complete its fiscal year 2021–22 reconciliations on time because of its delay in closing its fiscal year 2020–21 accounts. In the previous fiscal year, the department had stated that a lack of training and the need for additional staff delayed its timely completion of reconciliations. CalFire also stated that it was delayed because of the transition to the Financial Information System for California (FI$Cal), although it is unclear to us how that effort affected the timing of reconciliations, given that it started in January 2019.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to identify errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of a department's financial reports. Reconciliations shall be prepared monthly within 30 days of the end of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

CalFire should perform its monthly reconciliations to the accounts maintained by the State Controller in a timely manner.

CalFire should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.

CalFire should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

CalFire should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

Department's View and Corrective Actions:

CalFire stated that it agreed with the finding and recommendations and is implementing corrective actions. In addition, CalFire reiterated some of the challenges it continues to experience with FI$Cal.

GOVERNOR'S OFFICE OF BUSINESS AND ECONOMIC DEVELOPMENT

Reference Number: 2022-11

Condition:

Through the Budget Act of 2021, the Governor's Office of Business and Economic Development (GO-Biz) spent funding made available by the federal government under the American Rescue Plan Act of 2021. This funding was primarily for its Small Business COVID-19 Relief Grant Program. However, legislation enacted in June 2022 gave the Department of Finance (Finance) the flexibility to remove this funding, which it exercised in September 2022, thereby making it available to address other COVID-19 related costs. Consequently, GO-Biz was required to reimburse the Federal Fund with monies from its General Fund for any expenditures incurred by this program. Although GO-Biz was aware that Finance had decided to change the source of funding, it was not until after we inquired about this change that it revised its financial statements. Prior to this revision, GO-Biz overstated its revenues and expenditures in the Federal Fund, and understated its expenditures in the General Fund, by $1.6 billion.

GO-Biz stated that it was not aware of the requirement to revise its financial statements, which was necessary in this situation to address the executive order issued by Finance after the end of the fiscal year that affected amounts already reported to the State Controller's Office (State Controller). Moreover, although GO-Biz utilizes the services of the Department of General Services (DGS) for accounting and financial reporting, GO-Biz is ultimately responsible for reviewing its accounting records for accuracy and providing agency account adjustments to DGS.

Criteria:

State Administrative Manual section 8291 requires departments to record accruals accurately and in a timely manner as part of an effective system of internal controls.

Government Code section 12460 requires the State Controller to issue an Annual Comprehensive Financial Report (ACFR) that is prepared in accordance with generally accepted accounting principles (GAAP).

Codification of Governmental Accounting and Financial Reporting Standards section 1300 states that each fund must be accounted for in a separate self-balancing set of accounts. Section 1300 also differentiates between a government's general fund and other governmental funds.

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that the financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting, which requires the reporting of expenditures in the accounting period in which the liability is incurred.

Recommendation:

To ensure that its financial statements are properly presented and comply with GAAP, GO-Biz should develop a process to identify any accounting and reporting changes that must be communicated to the State Controller and revise its financial statements as needed.

Department's View and Corrective Actions:

GO-Biz agreed with our finding and recommendation. It stated that it has begun to develop a process to identify and communicate material accounting changes and to revise its financial statements as needed.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2022-12

Condition:

As we have reported for the past three fiscal years, the Department of Parks and Recreation (State Parks) has been unable to reconcile its capital asset account balances for buildings and related improvements to a subsidiary inventory ledger. Therefore, State Parks has not been reporting complete and accurate information to the State Controller's Office (State Controller) for inclusion in the State's Annual Comprehensive Financial Report (ACFR). During fiscal year 2021–22, we found that State Parks still lacks a comprehensive inventory of its capital assets and therefore continues to be unable to reconcile its account balances. As a result, for fiscal year 2021–22, State Parks reported the same capital assets to the State Controller that it reported in fiscal year 2017–18. Furthermore, similar to fiscal year 2020–21, State Parks continues to lack policies and procedures governing its reporting for roads and trails. At this time, based on the historical level of funding made available to State Parks, these issues do not pose a material risk of misstatement to the State's ACFR. Nevertheless, it is important for State Parks to implement our recommendations to avoid a possible material misstatement in the future.

According to State Parks' chief of accounting, the department's more recent efforts to implement our recommendations were delayed by the significant winter storms that occurred during December 2022 and January 2023.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section 1400.102 states that capital assets should be reported at historical cost. The cost of a capital asset should include ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly attributable to asset acquisition, such as freight and transportation charges, site preparation costs, and professional fees. Interest cost incurred before the end of a construction period should not be capitalized as part of the asset's historical cost. Donated capital assets should be reported at their acquisition value plus ancillary charges, if any.

Codification of Governmental Accounting and Financial Reporting Standards section 1400.104 states that capital assets should be depreciated over their estimated useful lives unless they are inexhaustible, are intangible assets with indefinite useful lives, or are infrastructure assets reported using the modified approach.

State Administrative Manual (SAM) section 8650.1 states that to maintain accountability of capital assets, departments are required to maintain a record of all property, whether capitalized or not, in a property accounting or inventory system.

SAM section 8650.2 states that when capital assets are acquired, departments will record certain information in their systems including the date acquired, property description, owner fund, and historical cost or other basis of valuation.

SAM section 7924 directs departments to reconcile acquisitions and dispositions of capitalized assets and property with the amounts recorded in the property register. The reconciliation should be done monthly or at least quarterly, depending on the volume of transactions.

SAM section 8652 states that departments are to make a physical count of all property and reconcile the count with their accounting records at least once every three years.

Recommendations:

To ensure that it properly reports its capital assets in its year-end financial statements, State Parks should take the following actions:

- Develop and communicate to staff a sound methodology for identifying and compiling relevant information about roads and trails, including asset values based on historical cost (or acquisition value for donated assets) and asset acquisition dates.
- Conduct a comprehensive inventory of capital assets.
- Update its subsidiary capital asset records in the Financial Information System for California (FI$Cal) to reflect the results of the inventory and ensure that its year-end financial reports reflect any necessary restatements.
- In accordance with SAM section 8652, conduct a physical count of all property and reconcile the count with its accounting records at least once every three years.

Department's View and Corrective Actions:

State Parks agrees with the findings and stated that it will take the following actions:

- Continue to work with subject matter experts to develop a standard per-unit cost for roads and trails.
- Complete a comprehensive inventory, which is currently underway, with all districts and divisions reviewing FI$Cal capital asset records.
- Update its FI$Cal capital asset records to reflect any necessary restatements from its comprehensive inventory.
- Conduct physical property inventories at least once every three years in accordance with SAM section 8652.

CALIFORNIA DEPARTMENT OF RESOURCES RECYCLING AND RECOVERY

Reference Number: 2022-13

Condition:

In prior fiscal years, we reported that the California Department of Resources Recycling and Recovery (CalRecycle) did not complete bank reconciliations or reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2021–22, CalRecycle continued to struggle to perform these reconciliations on time. For example, six of the 12 monthly bank reconciliations were significantly late, as CalRecycle completed each of them more than nine months after the 30-day requirement. Both the bank reconciliation and the monthly account reconciliation serve as important internal controls because they enable departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

Similarly, CalRecycle continued to submit late year-end financial reports to the State Controller. Compounding the issues identified above, CalRecycle submitted its year-end financial reports for fiscal year 2021–22 in November 2022, six months before it completed its June 2022 bank reconciliation in May 2023. The sequence of these tasks is concerning because the completion of bank reconciliations is a necessary control for ensuring that the information in the financial reports is accurate.

CalRecycle said that a lack of adequately trained personnel, resulting from significant turnover, was the main reason it was unable to perform timely reconciliations. Additionally, CalRecycle noted that its late completion of fiscal year 2020–21 financial reports was a significant contributing factor to the delayed completion of reconciliations in fiscal year 2021–22.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7923 requires departments to reconcile their bank account balances with the like accounts maintained in the Centralized Treasury Trust System (CTS). Departments must reconcile their general cash, revolving fund cash, and agency trust fund cash accounts with their CTS Account Statement bank balance, and adjust for deposits in transit, outstanding checks, and other reconciling items.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

CalRecycle should perform its monthly bank reconciliations and reconciliations to the accounts maintained by the State Controller in a timely manner, and it should do so before submitting timely financial reports to the State Controller.

CalRecycle should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.

CalRecycle should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

CalRecycle should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

CalRecycle agreed with our finding and said that it is committed to implementing our recommendations. It noted that it was able to fill its vacancies in March 2023. CalRecycle also said that it prioritizes the submission of all financial statements before completing the current year's reconciliations.

Comment:

To provide clarity and perspective, we are commenting on CalRecycle's response to our finding.

CalRecycle's statement that it prioritizes the submission of financial statements over the completion of reconciliations indicates that it does not adequately understand financial reporting requirements. When a department submits its financial statements to the State Controller, it certifies that the statements are accurate and complete. However, it would not be able to ensure the validity of that certification if it had not already completed its bank reconciliations. By prioritizing the submission of its financial statements over the completion of reconciliations, CalRecycle increases the risk that the information it submits to the State Controller contains errors that could cause the State's financial statements to be misstated.

STATE WATER RESOURCES CONTROL BOARD

Reference Number: 2022-14

Condition:

In prior fiscal years, we reported that the State Water Resources Control Board (SWRCB) did not reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2021–22, SWRCB continued to complete its reconciliations significantly late. For example, the agency completed its June 2022 reconciliation in January 2023, more than 5 months after the deadline of July 2022. As a result of the delayed reconciliations, SWRCB also submitted late year-end financial reports to the State Controller. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

SWRCB cited a significant staff vacancy rate and the time required to train new staff as contributing factors to the delays. It further noted that the delay in closing fiscal year 2020–21 accounts resulted in its late completion of fiscal year 2021–22 reconciliations. The department also commented that it has not been able to catch up on its reconciliations and close periods on time since it transitioned to FI$Cal.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of a department's financial reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

SWRCB should perform its monthly reconciliations and submit its financial reports to the State Controller in a timely manner.

SWRCB should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.

SWRCB should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

SWRCB should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

SWRCB agrees with our recommendations and states that it has begun implementing some of them.

MULTIPLE DEPARTMENTS IMPLEMENTING GOVERNMENTAL ACCOUNTING STANDARDS BOARD STATEMENT NUMBER 87

Reference Number: 2022-15

Condition:

Multiple departments were unable to ensure the reasonableness of the lease information they reported to the State Controller's Office (State Controller) for inclusion in the State's Annual Comprehensive Financial Report (ACFR) when implementing a new accounting standard. Specifically, Governmental Accounting Standards Board Statement Number 87 (GASB 87), *Leases*, establishes standards for accounting and financial reporting of leases, effective for fiscal year 2021–22. Accounting staff at three departments, who are responsible for ensuring the quality of their departments' lease reporting to the State Controller, were unable to describe the steps taken within their organizations to prepare this information. For example, accounting staff at the Department of Transportation (Caltrans) relied upon information prepared by other divisions within the department, but were themselves not aware of how this information was prepared, nor did they take sufficient steps to validate its reliability. We identified similar situations at the California Highway Patrol (CHP) and the Department of General Services (DGS). Consequently, we had to perform additional detailed audit procedures to mitigate the risk of a material misstatement to the ACFR.

Criteria:

GASB 87 defines a lease as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. GASB requires governments to account for any contract that meets this definition under the GASB 87 lease guidance.

GASB Concept Statement Number 1 establishes that information in financial reports must be reliable and comprehensive. GASB states that nothing material should be omitted from the information necessary to faithfully represent the underlying events and conditions.

Recommendations:

When implementing new accounting standards, departments should develop policies and procedures that address adequate implementation of the standards, including assigning roles and responsibilities to specific staff and developing methods for analyzing and preparing information used in support. Departments should also ensure that they adequately train their staff on the implementation of the standards.

Departments' Views and Corrective Actions:

CHP stated that it is working towards control measures to correct this deficiency by obtaining a Master Lease List from DGS. Using the DGS list, it plans to validate departmental information to ensure its list is a complete population list of leases. It also stated that it will continue to train staff on the implementation of the accounting standards for GASB 87.

DGS stated that it generally agrees with the recommendation and is willing to incorporate the recommendation identified. It also stated that it is firmly committed to implementing new accounting standards and developing accounting policies and procedures to comply with the standards.

Caltrans stated that it appreciated the recommendations but sought to clarify certain points. It noted that it verbally explained its GASB 87 process during the audit and provided methodologies it prepared. It further noted that it relied on its districts to prepare lease information because they have the greatest understanding of the lease contracts. Caltrans also noted that it validated the information provided by its districts to contracts that its accounting staff maintained.

Comment:

To provide clarity and perspective, we are commenting on Caltrans' response to our finding.

Although Caltrans states that it took certain actions, we would expect it to have developed policies and procedures documenting how it addressed the new GASB standard. The methodology Caltrans provided did not address the accounting team's processes for validating the accuracy and completeness of the lease data provided by the districts.

Financial Audit Team for the *State of California: Financial Report for the Fiscal Year Ended June 30, 2022,* Report 2022-001, and the *State of California: Internal Control and Compliance Audit Report for the Fiscal Year Ended June 30, 2022*, Report 2022-001.1

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