CALIFORNIA SINGLE AUDIT REPORT

2004 – 05

Arnold Schwarzenegger, Governor
State of California

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DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

ARNOLD SCHWARZENEGGER, GOVERNOR
STATE CAPITOL ■ ROOM 1145 ■ SACRAMENTO CA ■ 95814-4998 ■ WWW.DOF.CA.GOV

May 31, 2006

Mr. Daniel R. Levinson, Inspector General
Department of Health and Human Services
Room 5250, Cohen Building
330 Independence Avenue, S.W.
Washington, D.C. 20201

Dear Mr. Levinson:

As the Governor's fiscal representative, I submit to you the State of California Single Audit Report for the fiscal year ended June 30, 2005. The report contains the Independent Auditor's Reports on the state's general-purpose financial statements; compliance and internal control over financial reporting; compliance and internal control related to federal grants; and schedule of federal assistance. Although the Independent Auditor identified reportable conditions related to internal control over financial reporting, the conditions were not considered material and do not adversely affect the state's general-purpose financial statements. The Independent Auditor also identified reportable conditions related to internal control over compliance with major federal program requirements. No instances of noncompliance were considered material.

California provides its citizens with numerous state and federal programs. The mix of programs we provide makes us larger and more complex than most economic entities in the world. Such complexity, along with ever-present budget constraints, challenges us to meet the requirements of those programs and activities efficiently and effectively. Moreover, such operations must exist within a system of internal and administrative control that safeguards assets and resources and produces reliable financial information. Attaining these objectives and overseeing the financial and business practices of the state continues to be an important part of the Department of Finance's role.

The head of each state department is responsible for establishing and maintaining a system of internal accounting and administrative control within his or her department. Each state department with reportable internal control weaknesses or instances of noncompliance is responsible for developing and implementing corrective action plans. The Department of Finance will continue to provide leadership to ensure the proper financial operations and business practices of the state, and to ensure that internal controls exist for the safeguarding and effective use of assets and resources.

If you have any questions concerning this letter, please contact Diana L. Ducay, Chief, Office of State Audits and Evaluations, at (916) 322-2985.

Sincerely,

(Original Signed By: Stephen W. Kessler for)

MICHAEL C. GENEST
Director

Enclosure

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Overview of California's Economy, Fiscal Year 2004-05

Both the national and California economies grew at a solid pace in 2005, overcoming surging energy prices, tighter monetary policy, rising mortgage rates, and in the case of the national economy, three hurricanes.

Housing markets are cooling in much of the nation. Existing home sales slowed in late 2005, and price increases moderated. When sales slow down, home building usually is not far behind. The biggest risk to the outlook, particularly for the California economy, is a sharp slowdown in home building. Residential construction has accounted for a disproportionately large share of the job gains in the nation in the last several years.

California—Broad-Based Growth

Personal income—income received by California residents from all sources was up 6.2 percent from a year earlier in the first three quarters of 2005, slightly slower than its 6.6-percent growth in 2004 as a whole. On this broad measure, the state continues to do better than the nation, where personal income grew by 6 percent in the first three quarters of 2005.

Statewide taxable sales were up more than 6 percent from their level a year ago in the first half of 2005. An impressive gain, given that they grew by 9.1 percent in the first half of 2004.

Made-in-California merchandise exports were 6.2 percent higher than a year earlier in 2005. Although a good gain, it paled next to the 17-percent gain in 2004. The export destinations with the biggest gains were Canada, China, Mexico, and South Korea. Sharp drops in exports to Singapore and Hong Kong limited the total gain in exports to Asia considerably.

Like the nation, California enjoyed better job gains in 2005, and generally they were more widely distributed across major industries. California nonfarm payroll employment was 1.6 percent higher than in 2005. In 2004, nonfarm payroll employment grew just 1 percent. The improvement was due primarily to a swing from large job losses to

small job gains in government and manufacturing, and bigger job gains in professional and business services.

Not only was the state's job growth better distributed across industries in 2005, it was also better distributed across major regions. Job growth in the San Francisco Bay Area was just shy of that in Southern California. The last time they were that close was over four years ago. While nonfarm payroll employment remains considerably below pre-recession peak levels in the Bay Area, the region was definitely contributing to job growth in the state.

Home building was fairly robust during most of 2005. Building activity slowed noticeably at the end of the year, however. Housing permit issuances (number of units) during the first ten months of 2005 rose 2.8 percent from the same months of 2004. However, permits slowed nearly 25 percent during the last two months compared to a year earlier. In contrast, the dollar value of private nonresidential construction permits gradually rose throughout the year and was up over 16 percent for the year as a whole.

Similar to residential construction, home sales did well most of the year, but slowed dramatically towards the end of 2005. Despite the fact that sales of single-family homes grew 3.7 percent during the first nine months of the year, sales were essentially stagnant for the year as a whole.

The major risk for the outlook of the California economy is a sharp slowdown in residential construction. A disproportionate share of the state's recent job gains have come from construction and related industries. Construction alone accounted for over 35 percent of the total gain in nonfarm payroll employment in 2004, and nearly 25 percent in 2005.

As the fourth year of economic expansion came to a close, the national and California economies were fundamentally sound. Hurricane damage to the Gulf Coast oil industry infrastructure and cooling housing markets in California and other areas of the nation have created new risks to the outlook for the two economies. Each should be able to weather the expected higher energy prices and reduced homebuilding, and continue to expand for several years.

Part One

State of California: Financial Report for the Year Ended June 30, 2005

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CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the accompanying 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, 2005, which collectively comprise the State of California's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of California's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 49 percent, and 51 percent, respectively, of the assets, net assets, and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets, net assets, and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.
- Certain nonmajor enterprise funds that represent 87 percent, 78 percent, and 85 percent, respectively, of the assets, net assets, and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System, State Teachers' Retirement System, and the University of California Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as they relate to the amounts included for those funds and entities, is based on the reports of the other auditors.

We conducted our audit in accordance with 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 of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts

and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position 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 June 30, 2005, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis, schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances and related notes are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we express no opinion on them.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

February 28, 2006

Management's Discussion and Analysis

The following Management's Discussion and Analysis is a required supplement to the State of California's financial statements. It describes and analyzes the financial position of the State, providing an overview of the State's activities for the year ended June 30, 2005. We encourage readers to consider the information we present here in conjunction with the information presented in the letter of transmittal at the front of this report and in the State's financial statements and notes, which follow this section.

Financial Highlights – Primary Government

Government-wide Highlights

The State experienced healthy increases in general revenues, primarily personal income, corporate, and sales tax revenues and stabilized its expenses. As a result, for the first time in the past four fiscal years, State revenues exceeded expenses and transfers for governmental activities. Total revenues for the State's business-type activities also exceeded expenses for the year. Therefore, net assets for the 2004-05 fiscal year for both governmental and business-type activities increased by 10.3% over last year.

Net Assets — The primary government's net assets as of June 30, 2005, were $44.2 billion. After the total net assets are reduced by $80.4 billion for investment in capital assets (net of related debt) and by $14.9 billion for restricted net assets, the resulting unrestricted net assets were a negative $51.1 billion. Restricted net assets are dedicated for specified uses and are not available to fund current activities. More than half of the negative $51.1 billion consists of $29.7 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. The bonded debt reduces the unrestricted net assets; however, local governments, instead of the State, record the capital assets that would offset this reduction.

Changes in Net Assets — The primary government's total net assets increased by $4.1 billion (10.3%) during the year ended June 30, 2005. Net assets of governmental activities increased by $2.5 billion (7.9%), while net assets of business-type activities increased by $1.6 billion (19.8%).

Fund Highlights

Governmental Funds — As of June 30, 2005, the primary government's governmental funds reported a combined ending fund balance of $14.4 billion, an increase of $2.8 billion from the previous fiscal year. After the total fund balance is reduced by $16.5 billion in reserves, the unreserved fund balance totaled a negative $2.1 billion.

Proprietary Funds — As of June 30, 2005, the primary government's proprietary funds reported combined ending net assets of $10.3 billion, an increase of $1.6 billion from the previous fiscal year. After the total net assets are reduced by $1.3 billion for investment in capital assets (net of related debt) and expendable restrictions of $7.2 billion, the unrestricted net assets totaled $1.8 billion.

Noncurrent Assets and Liabilities

As of June 30, 2005, the primary government's noncurrent assets totaled $118.8 billion, of which $93.6 billion is related to capital assets. State highway infrastructure assets of $55.1 billion represents the largest part of the State's capital assets.

The primary government's noncurrent liabilities totaled $92.3 billion, which consists of $45.8 billion in general obligation bonds, $30.0 billion in revenue bonds, and $16.5 billion in all other noncurrent liabilities.

Overview of the Financial Statements

This discussion and analysis is an introduction to the section presenting the State's basic financial statements, which includes four components: (1) government-wide financial statements, (2) fund financial statements, (3) discretely presented component units financial statements, and (4) notes to the financial statements. This report also contains required supplementary information and combining financial statements and schedules.

Government-wide Financial Statements

Government-wide financial statements are designed to provide readers with a broad overview of the State's finances. The government-wide financial statements do not include fiduciary programs and activities of the primary government and component units because fiduciary resources are not available to support state programs.

To help readers assess the State's economic condition at the end of the fiscal year, the statements provide both short-term and long-term information about the State's financial position. These statements are prepared using the economic resources measurement focus and the accrual basis of accounting, similar to methods used by most businesses. These statements take into account all revenues and expenses connected with the fiscal year, regardless of when the State received or paid the cash. The government-wide financial statements include two statements: the Statement of Net Assets and the Statement of Activities.

- The *Statement of Net Assets* presents all of the State's assets and liabilities and reports the difference between the two as net assets. Over time, increases or decreases in net assets indicate whether the financial position of the State is improving or deteriorating.

- The *Statement of Activities* presents information showing how the State's net assets changed during the most recent fiscal year. The State reports changes in net assets as soon as the event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, this statement reports revenues and expenses for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the State.

The government-wide financial statements separate into different columns the three types of state programs and activities: governmental activities, business-type activities, and component units.

- *Governmental activities* are mostly supported by taxes, such as personal income and sales and use taxes, and intergovernmental revenues, primarily federal grants. Most services and expenses normally associated with state government fall into this activity category, including health and human services, education (public kindergarten through 12th grade [K-12] schools and institutions of higher education),

business and transportation, correctional programs, general government, resources, tax relief, state and consumer services, and interest on long-term debt.

- *Business-type activities* typically recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The business-type activities of the State of California include providing unemployment insurance programs, providing housing loans to California veterans, providing water to local water districts, providing building aid to school districts, operating toll collection facilities, providing services to California State University students, leasing public assets, selling California State Lottery tickets, and selling electric power. These activities are carried out with minimal financial assistance from the governmental activities or general revenues of the State.

- *Component units* are organizations that are legally separate from the State, but are at the same time related to the State either financially (i.e., the State is financially accountable for them), or the nature of their relationship with the State is so significant that their exclusion would cause the State's financial statements to be misleading or incomplete. The State of California has blended, fiduciary, and discretely presented component units.

  - *Blended component units*, although legally separate entities, are in substance a part of the primary government's operations. Therefore, for reporting purposes, the State integrates data from blended component units into the appropriate funds. The Golden State Tobacco Securitization Corporation, the California State University, Channel Islands Site and Financing authorities, and certain building authorities that are blended component units of the State are included in the governmental activities.

  - *Fiduciary component units* are legally separate from the primary government but, due to their fiduciary nature, are included with the primary government's fiduciary funds. The Public Employees' Retirement System, the State Teachers' Retirement System, and the University of California Retirement System are fiduciary component units that are included with the State's pension and other employee benefit trust funds, which are not included in the government-wide financial statements.

  - *Discretely presented component units* are legally separate from the primary government and provide services to entities and individuals outside the primary government. The activities of discretely presented component units are presented in a single column in the government-wide financial statements.

Information on how to obtain financial statements of the individual component units is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, CA 94250.

Fund Financial Statements

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The State of California, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal and contractual requirements. Following are general descriptions of the three types of funds.

- *Governmental funds* are used to account for essentially the same functions that are reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on short-term inflows

and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's short-term financing requirements. This approach is known as the flow of current financial resources measurement focus and the modified accrual basis of accounting. These governmental fund statements provide a detailed short-term view of the State's finances, enabling readers to determine whether adequate financial resources exist to meet the State's current needs.

Because governmental fund financial statements provide a narrower focus than do government-wide financial statements, it is useful to compare governmental fund statements to the governmental activities information presented in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's short-term financing decisions. Reconciliations located on the pages immediately following the fund statements show the differences between the government-wide statements and the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures, and Changes in Fund Balances. Primary differences between the government-wide and fund statements relate to noncurrent assets, such as land and buildings, and noncurrent liabilities, such as bonded debt and amounts owed for compensated absences and capital lease obligations, which are reported in the government-wide statements but not in the fund-based statements.

- *Proprietary funds* show activities that operate more like those found in the private sector. The State of California has two proprietary fund types: enterprise funds and internal service funds.
  - *Enterprise funds* record activities for which a fee is charged to external users; they are presented as business-type activities in the government-wide financial statements.
  - *Internal service funds* accumulate and allocate costs internally among the State of California's various functions. For example, internal service funds provide information technology, printing, fleet management, and architectural services primarily for state departments. As a result, their activity is considered governmental.
- *Fiduciary funds* account for resources held for the benefit of parties outside the State. Fiduciary funds and the activities of fiduciary component units are not reflected in the government-wide financial statements, because the resources of these funds are not available to support State of California programs. The accounting used for fiduciary funds and similar component units is similar to that used for proprietary funds.

Discretely Presented Component Units Financial Statements

As discussed previously, the State has financial accountability for discretely presented component units, which have certain independent qualities and operate similarly to private-sector businesses. The activities of the discretely presented component units are classified as enterprise activities.

Notes to the Financial Statements

The notes to the financial statements in this publication provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements, which describe particular accounts in more detail, are located immediately following the discretely presented component units' financial statements.

Required Supplementary Information

A section of required supplementary information follows the notes to the basic financial statements in this publication. This section includes a schedule of funding progress for certain pension trust funds, information on infrastructure assets based on the modified approach, a budgetary comparison schedule, and a separate reconciliation of the statutory fund balance for budgetary purposes and the fund balance for the major governmental funds presented in the governmental fund financial statements.

Combining Financial Statements and Schedules

The Combining Financial Statements and Schedules – Nonmajor and Other Funds section presents *combining statements* that provide separate financial statements for nonmajor governmental funds, proprietary funds, fiduciary funds, and nonmajor component units. The basic financial statements present only summary information for these entities.

Government-wide Financial Analysis

Net Assets

The primary government's combined net assets (governmental and business-type activities) increased 10.3%, from $40.1 billion, as restated at June 30, 2004, to $44.2 billion a year later. This was a positive change from the 17.5% decline reported for the 2003-04 fiscal year.

A significant portion of the primary government's net assets is its $80.4 billion investment in capital assets, such as land, building, equipment, and infrastructure (roads, bridges, and other immovable assets). This amount of capital assets is net of any outstanding debt used to acquire those assets. The State uses capital assets when providing services to citizens; consequently, these assets are not available for future spending. Although the State's investment in capital assets is reported in this publication net of related debt, please note that the resources needed to repay this debt must come from other sources because the State cannot use the capital assets themselves to pay off the liabilities.

Another $14.9 billion of the primary government's net assets represents resources that are externally restricted as to how they may be used, such as resources pledged to debt service. Internally imposed earmarking of resources is not presented in this publication as restricted net assets. The State may use a positive balance of unrestricted net assets of governmental activities to meet its ongoing obligations to citizens and creditors. As of June 30, 2005, governmental activities showed an unrestricted net assets deficit of $52.6 billion and business-type activities showed unrestricted net assets of $1.6 billion.

A large portion of the negative unrestricted net assets of governmental activities is composed of $29.7 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. Because the State does not own these capital assets, neither the assets nor the related bonded debt is included in the portion of net assets reported as "investment in capital assets, net of related debt." Instead, the bonded debt is reported as a non-current liability that reduces the State's unrestricted net assets. Readers can expect to see a continued deficit in unrestricted net assets of governmental activities as long as the State has significant outstanding obligations for school districts and other local governmental entities.

Table 1 presents condensed financial information derived from the Statement of Net Assets for the primary government.

Table 1

Net Assets – Primary Government
June 30, 2005
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2005	2004*	2005	2004*	2005	2004*
ASSETS						
Current and other assets	$ 43,094	$ 37,149	$ 32,661	$ 31,037	$ 75,755	$ 68,186
Capital assets	87,178	85,248	6,410	6,070	93,588	91,318
Total assets	**130,272**	**122,397**	**39,071**	**37,107**	**169,343**	**159,504**
LIABILITIES						
Noncurrent liabilities	65,953	64,333	26,383	25,912	92,336	90,245
Other liabilities	29,739	26,101	3,050	3,153	32,789	29,254
Total liabilities	**95,692**	**90,434**	**29,433**	**29,065**	**125,125**	**119,499**
NET ASSETS						
Investment in capital assets net of related debt	79,580	77,734	837	1,058	80,417	78,792
Restricted	7,631	7,126	7,235	5,667	14,866	12,793
Unrestricted	(52,631)	(52,897)	1,566	1,317	(51,065)	(51,580)
Total net assets	**$ 34,580**	**$ 31,963**	**$ 9,638**	**$ 8,042**	**$ 44,218**	**$ 40,005**

*Not restated

Changes in Net Assets

The expenses of the primary government totaled $167.4 billion for the year ended June 30, 2005. Of this amount, $79.8 billion (47.7%) was funded with program revenues (charges for services or program-specific grants and contributions), leaving $87.6 billion to be funded with general revenues (mainly taxes). For the first time since fiscal year 2001-02, when the State began presenting primary government net assets, the primary government's general revenues and transfers of $91.7 billion exceeded the net unfunded expenses. As a result, during the year total net assets increased by $4.1 billion, or 10.3%.

Of the total increase, net assets for governmental activities increased by $2.5 billion, while those for business-type activities increased by $1.6 billion. The increase in governmental activities is due to healthy increases in personal income, corporate, and sales tax revenues. The increase in business-type activities is mainly due to employer contributions and other revenue for unemployment programs exceeding unemployment benefit payments.

Table 2 presents condensed financial information derived from the Statement of Activities for the primary government.

Table 2

Changes in Net Assets – Primary Government
Year ended June 30, 2005
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2005	**2004**	**2005**	**2004**	**2005**	**2004**
REVENUES						
Program revenues:						
Charges for services	$ 16,040	$ 13,121	$ 21,417	$ 19,595	$ 37,457	$ 32,716
Operating grants and contributions	41,135	41,072	—	—	41,135	41,072
Capital grants and contributions	1,090	917	73	48	1,163	965
General revenues:						
Taxes	90,908	80,056	—	—	90,908	80,056
Investment and interest	289	155	—	—	289	155
Miscellaneous	526	687	—	—	526	687
Total revenues	**149,988**	**136,008**	**21,490**	**19,643**	**171,478**	**155,651**
EXPENDITURES						
Program expenses:						
General government	8,809	8,011	—	—	8,809	8,011
Education	53,153	51,458	—	—	53,153	51,458
Health and human services	62,017	60,021	—	—	62,017	60,021
Resources	4,161	4,436	—	—	4,161	4,436
State and consumer services	1,038	1,029	—	—	1,038	1,029
Business and transportation	7,142	7,579	—	—	7,142	7,579
Correctional programs	6,611	6,215	—	—	6,611	6,215
Tax relief	2,157	3,007	—	—	2,157	3,007
Interest on long-term debt	2,408	1,738	—	—	2,408	1,738
Electric Power	—	—	5,655	5,203	5,655	5,203
Water Resources	—	—	731	731	731	731
Public Building Construction	—	—	300	297	300	297
State Lottery	—	—	3,494	3,348	3,494	3,348
Unemployment Programs	—	—	8,940	10,272	8,940	10,272
Nonmajor enterprise	—	—	746	770	746	770
Total expenses	**147,496**	**143,494**	**19,866**	**20,621**	**167,362**	**164,115**
Excess (deficiency) before transfers	**2,492**	**(7,486)**	**1,624**	**(978)**	**4,116**	**(8,464)**
Transfers	28	33	(28)	(33)	—	—
Change in net assets	2,520	(7,453)	1,596	(1,011)	4,116	(8,464)
Net assets, beginning of year (restated)	**32,060**	**39,416**	**8,042 ***	**9,053**	**40,102**	**48,469**
Net assets, end of year	**$ 34,580**	**$ 31,963**	**$ 9,638**	**$ 8,042**	**$ 44,218**	**$ 40,005**

* Not restated

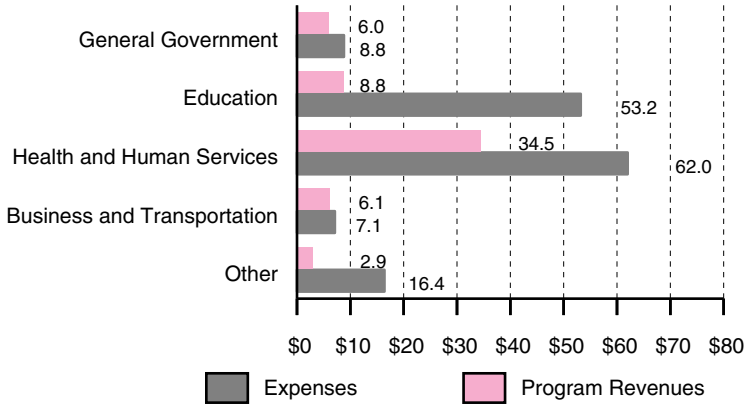
Governmental Activities

Governmental activities expenses totaled $147.5 billion. Program revenues funded only $58.3 billion (39.5%) of that amount, including $42.2 billion received in federal grants, and general revenues (mainly taxes) funded $89.2 billion. General revenues and transfers for governmental activities totaled $91.7 billion. Thus, governmental activities' total net assets increased by $2.5 billion, or 7.9%, during the year ended June 30, 2005.

Chart 1 presents a comparison of governmental activities expenses by program, with related revenues.

Chart 1

Expenses and Program Revenues – Governmental Activities
Year Ended June 30, 2005
(amounts in billions)



For the year ended June 30, 2005, total state tax revenues collected for governmental activities increased by 13.6% over last year. The largest increase in state tax revenue occurred in personal income taxes, due to stock market gains and capital gains related to the strong real estate market. Also, in February 2005, the State initiated a tax amnesty program that generated cash receipts of approximately $3.8 billion in the 2004-05 fiscal year. However, the State expects to refund in future years an estimated $1.5 billion of the amount received from protective claims. Consequently, it established a tax overpayment liability for this amount.

Overall expenses for governmental activities increased slightly from the prior year – a $4.0 billion (or 2.8%) increase. While the expenses for some activities increased, the expenses for other activities decreased. The largest increases in expenses were a $1.7 billion increase in education spending and a $2.0 billion increase in health and human services spending. The largest decrease in expenses was an $850 million decrease in tax relief. The increase in education expenses and the decrease in tax relief were mostly attributable to a shift in General Fund spending from tax relief payments for local governments to education expenditures for schools and community colleges as a result of an agreement with local governments. The increase in health and human services spending was the result of increased medical and social services caseloads.

Charts 2 and 3 present the percentage of total expenses for each program of governmental activities and the percentage of total revenues by source.

Chart 2

Expenses by Program
Year ended June 30, 2005
(as a percent)

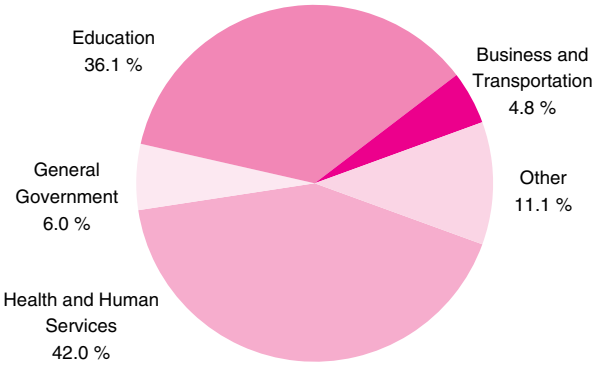
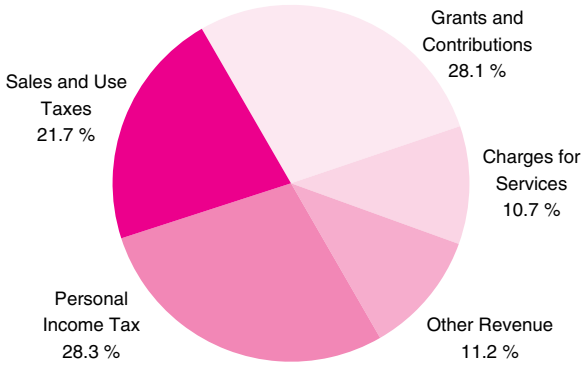


Chart 3

Revenues by Source
Year ended June 30, 2005
(as a percent)



Business-type Activities

Business-type activities expenses totaled $19.9 billion. Program revenues of $21.5 billion were generated primarily from charges for services which fully paid these expenses. Consequently, business-type activities' total net assets increased by $1.6 billion, or 19.8%, during the year ended June 30, 2005.

Most of the increase in net assets was due to a $1.5 billion increase in unemployment programs' net assets, discussed in more detail in the Fund Financial Analysis section under Proprietary Funds. For the first time in several years, the revenues of the unemployment programs exceeded expenditures and transfers, as a result of increased tax rates and a modest increase in employment.

Chart 4 presents a two year comparison of the expenses of the State's business-type activities.

Chart 4

Expenses – Business-type Activities – Two Year Comparison
Year Ended June 30
(amounts in billions)

Fund Financial Analysis

The financial position of the State's governmental funds continued to improve significantly in the 2004-05 fiscal year. Governmental funds rely heavily on taxes to support the majority of the State's services and programs. Personal income, corporate, and sales taxes increased markedly during the year, eliminating the prior year's General Fund deficit. On the other hand, only one of the major proprietary funds, the Unemployment Programs Fund, had total revenues that were significantly different from total expenses during the year ended June 30, 2005.

Governmental Funds

The governmental funds Balance Sheet reported $48.1 billion in assets, $33.7 billion in liabilities, and $14.4 billion in fund balance as of June 30, 2005. The largest change in account balance was a $5.8 billion increase in cash and pooled investments that relates to the higher-than-expected increase in state tax revenue. Within the total fund balance, $16.5 billion has been set aside in reserve. The reserved amounts are not available for new spending, because they have been committed for outstanding contracts and purchase orders ($6.3 billion), noncurrent interfund receivables and loans receivable ($4.8 billion), and continuing appropriations ($5.4 billion). The unreserved balance of the governmental funds is a negative $2.1 billion.

The Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds shows $149.8 billion in revenues, $152.6 billion in expenditures, and a net $5.6 billion in receipts from other financing sources (uses). The ending fund balance of the governmental funds for the year ended June 30, 2005, was $14.4 billion, a $2.8 billion increase over the previous year's restated ending fund balance of $11.6 billion. The increase in the combined fund balance of the governmental funds was a result of an increase in state tax revenues, including sales and use taxes, in both the General Fund and the nonmajor governmental funds. Personal income taxes, which account for 47.0% of tax revenues and 28.4% of total governmental fund revenues, increased by $4.9 billion over the previous fiscal year. The increase in state tax revenues is attributable to the growth in the economy, fueled by the recovery of the stock market, capital gains from brisk real estate market activity, and strength in consumer spending.

The State's major governmental funds are the General Fund, the Federal Fund, and the Transportation Construction Fund. The General Fund ended the fiscal year with a fund balance of $187 million. The Federal Fund and the Transportation Construction Fund ended the fiscal year with fund balances of $27 million and $3.7 billion, respectively. The nonmajor governmental funds ended the year with a total fund balance of $10.5 billion.

General Fund: As shown on the Balance Sheet, the General Fund (the State's main operating fund) ended the fiscal year with assets of $17.7 billion, liabilities of $17.5 billion, and fund balance reserves of $1.6 billion, leaving the General Fund with an unreserved fund deficit of $1.4 billion. The largest change in asset accounts was in cash and pooled investments, which increased from $3.6 billion to $8.1 billion. The increase is primarily due to higher-than-expected cash receipts associated with the State's tax amnesty program, which concluded in early April 2005. No expenditures were budgeted to use this unexpected increase, so the cash remained available in pooled investments at June 30, 2005.

The largest changes in liability account balances were an increase of 55.9% in due to other funds (from $3.4 billion to $5.3 billion) and an increase of 46.7% in tax overpayments (from $3.0 billion to $4.4 billion). The increase in the amount due to other funds was caused mainly by a $1.2 billion accrued transfer from the General Fund to the Local Revenue Fund (a nonmajor special revenue fund) to repay the vehicle license fee gap loan from local governments. This transfer is included in the 2005-06 General Fund budget. The increase in tax overpayments represents the estimated $1.5 billion of tax refunds that the State may make in future years to taxpayers who made payments through protective claims during the tax amnesty program. Taxpayers made these payments to avoid being charged high post-amnesty penalties in the event that their outstanding tax challenges are not ultimately upheld, or they receive future audit assessments related to past tax years. Should the taxpayers prevail in their disputes, the State will have to make refunds. If the State prevails, additional tax revenue will be reported.

As shown on the Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds, the General Fund had $84.3 billion in revenues, $80.4 billion in expenditures, and a net $2.2 billion disbursement from other financing sources (uses) for the year ended June 30, 2005. The largest source of General Fund revenue was $82.4 billion in taxes, comprised primarily of personal income taxes ($42.4 billion) and sales and use taxes ($25.8 billion).

The taxes with the largest increase in revenues were personal income taxes, which increased by $4.7 billion (12.5%), and corporation income taxes, which increased by $2.8 billion (33.6%). These increases can be attributed to the higher-than-expected revenues from the previously mentioned tax amnesty program, reported net of the estimated refunds for overpayments, along with the growth in the economy. Sales and use taxes increased by $1.9 billion (8.1%), to $25.8 billion; this increase can be attributed to strong consumer spending.

General Fund expenditures increased by $6.7 billion, to $80.4 billion. The programs with the largest increases were education, which increased by $4.6 billion, to $40.9 billion; correctional programs, which increased by $1.4 billion, to $6.6 billion; and health and human services which increased by $1.3 billion, to $24.8 billion. Offsetting these increases was a decrease in the tax relief program of $2.0 billion, to only $949 million.

The increase in education expenditures and the decrease in the tax relief programs can be attributed in large part to the State's agreement with local governments that shifted property taxes from schools to other local governments in return for the elimination of vehicle license fee backfill payments from the General Fund. The General Fund replaced the redirected property taxes to K-12 schools and community colleges through additional payments and discontinued making vehicle license fee backfill payments to local governments. In addition, as the quarter-cent sales tax is diverted from local governments to repay the Economic Recovery Bonds, property taxes are shifted from schools to other local governments. The State's education expenditures

increase correspondingly to compensate schools for the loss in property taxes. Correctional program expenditures were higher because in fiscal year 2003-04, the State used federal flexible assistance grants that were not available in fiscal year 2004-05 to offset state spending for the program. Health and human service expenditures increased primarily because Medi-Cal spending in fiscal year 2003-04 was reduced by a one-time increase in federal funds for the program and because medical and social services caseloads increased. The General Fund's ending fund balance (including reserves) for the year ended June 30, 2005, was $187 million, which is an increase of $1.7 billion over the previous year's ending fund deficit of $1.5 billion.

Federal Fund: This fund reports federal grant revenues and the related expenditures to support the grant programs. The largest of these program areas is health and human services, which accounted for $29.8 billion (74.1%) of the total $40.2 billion in fund expenditures. The Medical Assistance Program and the Temporary Assistance for Needy Families program are included in this program area. Education programs also constituted a large part of the fund's expenditures – $6.6 billion (16.4%) – most of which were apportionments made to local educational agencies (school districts, county offices of education, community colleges, etc.).

Total revenues and expenditures remained fairly constant, resulting in less than a 1.0% change from the prior year. In 2004, the State issued Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds). For the first time, the Federal Fund reported debt service expenditures, and its fund balance decreased $29 million, to $27 million, primarily due to the $65 million GARVEE bond debt service expenditures.

Transportation Construction Fund: This fund accounts for gasoline taxes, bond proceeds, and other revenues used for highway and passenger rail construction. Revenues increased 7.1%, while expenditures remained stable with less than a 1.0% change from the prior year. Fund revenues of $3.6 billion exceeded expenditures by only $4 million. However, the fund balance increased by $42 million, due to the issuance of $80 million in commercial paper for Bay Area toll bridges seismic retrofit projects.

Proprietary Funds

Enterprise Funds: In general, the solid growth of the economy did not have as significant an effect on enterprise funds as it did on governmental funds. Most major enterprise funds' activity remained stable, as revenues approximated expenses. The exception was the Unemployment Programs Fund, which had revenues that exceeded expenditures and transfers by $1.5 billion.

As shown on the Statement of Net Assets of the proprietary funds, total assets of the enterprise funds were $39.7 billion as of June 30, 2005. Of this amount, current assets totaled $11.1 billion and noncurrent assets totaled $28.6 billion. The largest changes in asset account balances were in cash and pooled investments and the amount on deposit with the U.S. Treasury for unemployment programs. For the first time in several years, Unemployment Programs Fund revenues exceeded expenditures and transfers, leading to a total increase of $1.6 billion in these two account balances. The total liabilities of the enterprise funds were $30.1 billion. The largest liability accounts were revenue bonds payable of $22.0 billion and general obligation bonds payable of $2.0 billion. The 1.6% increase in total liabilities was mainly in revenue bonds payable because new bonds issued during the year exceeded the redemption paid on outstanding bonds.

Total net assets of the enterprise funds were $9.6 billion as of June 30, 2005. Total net assets consisted of three segments: expendable restricted net assets of $7.2 billion; investment in capital assets (net of related debt) of $837 million; and unrestricted net assets of $1.6 billion. The Unemployment Programs Fund had the largest net assets, with $4.1 billion (42.1% of the enterprise funds' total net assets). The expendable restricted net assets of the Unemployment Programs Fund increased by $1.5 billion due to the net income generated this year.

As shown on the Statement of Revenues, Expenses, and Changes in Fund Net Assets of the proprietary funds, the enterprise funds ended the year with operating revenues of $20.2 billion, operating expenses of $17.4 billion, and net disbursements from other transactions of $1.2 billion. The largest sources of operating revenue were unemployment and disability insurance receipts of $10.2 billion in the Unemployment Programs Fund and power sales of $4.7 billion collected by the Electric Power Fund. The largest operating expenses were distributions to beneficiaries of $8.7 billion by the Unemployment Programs Fund and power purchases (net of recoverable costs) of $4.7 billion by the Electric Power Fund. The ending net assets of the enterprise funds for the year ended June 30, 2005, were $9.6 billion, or $1.6 billion more than the previous year's ending fund balance of $8.0 billion. The main reason for the increase was the $1.5 billion gain from the Unemployment Programs Fund. The net assets of the Unemployment Programs Fund had been declining for the last several years because state law nearly doubled the maximum weekly benefit amount over a phased-in period ending in 2005, but did not raise the taxable wage base or increase the tax rate schedules. To prevent a projected deficit in 2004, the State used higher tax rate schedules in order to generate a $1.7 billion increase in unemployment and disability insurance receipts for the year ended June 30, 2005. Recent economic growth and the corresponding modest increase in employment actually decreased distributions to beneficiaries by $1.3 billion compared to prior year expenses.

Internal Service Funds: Total net assets of the internal service funds were $616 million as of June 30, 2005. These net assets consist of two segments: investment in capital assets (net of related debt) of $425 million and unrestricted net assets of $191 million.

Fiduciary Funds

The State of California has four types of fiduciary funds: private purpose trust funds, pension and other employee benefit trust funds, investment trust funds, and agency funds. The private purpose trust funds ended the fiscal year with net assets of $1.7 billion. The pension and other employee benefit trust funds ended the fiscal year with net assets of $379 billion. The State's only investment trust fund, the Local Agency Investment Fund, ended the fiscal year with net assets of $18.6 billion. Agency funds act as clearing accounts and thus do not have net assets.

For the year ended June 30, 2005, the fiduciary funds' combined net assets were $399 billion, a $36.8 billion increase from the prior year. The main reason for the increase in net assets was an increase in the fair value of investments of retirement funds.

The Economy for the Year Ending June 30, 2005

The California economy picked up speed in fiscal year 2004-05 and by the end of the fiscal year had regained all of the jobs lost since the 2001 recession. From June 2004 to June 2005, nonfarm payroll employment added 243,900 jobs, representing an annual growth rate of 1.7%, more than twice as fast as in the previous fiscal year. Income growth was also strong, getting a significant boost from both job growth and capital gains.

Despite short-term interest rate increases from the Federal Open Market Committee, mortgage rates remained low and the real estate market continued its upsurge. Home sales and prices reached record levels, and residential construction activity was strong. While professional and business services added more jobs (55,900) than any other single sector, construction gained a reported 54,500 jobs. Together, construction and financial activities provided 32.8% of the job growth in the fiscal year.

General Fund Budget Highlights

The original General Fund budget of $82.2 billion was reduced by $892 million, mainly due to the transfer of $2.0 billion from the Deficit Recovery Fund that was recorded as a reimbursement of current year expenditures. The budget increase of $626 million for correctional programs can be attributed primarily to a change in the amount budgeted for employer contributions for retirement benefits and salary adjustments. During the 2004-05 fiscal year, General Fund actual expenditures were $79.7 billion, $1.6 billion less than the final budgeted amounts.

Table 3

General Fund Original and Final Budgets
Year ended June 30, 2005
(amounts in millions)

	Original	Final	Increase/ (Decrease)
Budgeted amounts			
State and consumer services	$ 514	$ 539	$ 25
Business and transportation	14	14	0
Resources	697	787	90
Health and human services	25,645	25,885	240
Correctional programs	6,171	6,797	626
Education	40,907	41,117	210
General government:			
Tax relief	952	952	0
Debt service	3,152	3,153	1
Other general government	4,119	2,035	(2,084)
Total	**$ 82,171**	**$ 81,279**	**$ (892)**

Capital Assets and Debt Administration

Capital Assets

The State's investment in capital assets for its governmental and business-type activities as of June 30, 2005, amounted to $93.6 billion (net of accumulated depreciation). This investment in capital assets includes land, state highway infrastructure, collections, buildings and other depreciable property, and construction in progress. Depreciable property includes buildings, improvements other than buildings, equipment, personal property, intangible assets, certain infrastructure assets, certain books, and other capitalized and depreciable property. Infrastructure assets are items that are normally immovable and can be preserved for a greater number of years than most capital assets. Infrastructure assets include roads, bridges, streets and sidewalks, drainage systems, and lighting systems.

Table 4 presents a summary of the primary government's capital assets for governmental and business-type activities.

Table 4

Capital Assets
Year ended June 30, 2005
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Land	$ 14,730	$ 46	$ 14,776
State highway infrastructure	55,115	—	55,115
Collections – nondepreciable	19	—	19
Buildings and other depreciable property	19,688	7,998	27,686
Less: accumulated depreciation	(8,002)	(3,246)	(11,248)
Construction in progress	5,628	1,613	7,241
Total	**$ 87,178**	**$ 6,411**	**$ 93,589**

The budget authorized $1.6 billion for the State's capital outlay program in the 2004-05 fiscal year, not including funding for state highway infrastructure, K-12 schools, state conservancies, and state water projects. State highway infrastructure assets are discussed in more detail in the Required Supplementary Information that follows the notes to the financial statements. Of the $1.6 billion authorized, $38 million was from the General Fund, $166 million was from lease-revenue bonds, and $1.4 billion was from proceeds of various general obligation bonds. The major capital projects authorized include:

- $1.3 billion for numerous construction projects within the University of California, the California State University, and the California Community Colleges;
- $73 million to address critical infrastructure needs at the California School for the Deaf in Riverside;
- $83 million for the Department of Parks and Recreation for acquisitions and projects that address critical safety issues and Off-Highway Vehicle Park improvements;
- $24 million for the Department of Corrections to address critical infrastructure deficiencies, security concerns, and health and safety issues; and
- $19 million for the Department of Food and Agriculture to complete the relocation of an Agricultural Inspection Station in the town of Truckee.

Note 7, Capital Assets, includes additional information on the State's capital assets.

Modified Approach for Infrastructure Assets

The State has adopted the Modified Approach as an alternative to depreciating the cost of its infrastructure (state roadways and bridges). Under the Modified Approach, the State will not report depreciation expense for roads and bridges but will capitalize all costs that add to the capacity and efficiency of State-owned roads and bridges. All maintenance and preservation costs will be expensed and not capitalized. Under the Modified

Approach, the State must maintain an asset management system and demonstrate that it is preserving the infrastructure at or above established condition levels. The State is responsible for maintaining approximately 49,600 lane miles and 12,100 bridges.

During the 2004-05 fiscal year, the actual amount spent on preservation was 78.3% of the estimated budgeted amount needed to maintain the infrastructure assets at the established condition levels. Although the amount spent fell short of the budgeted amount, the State's bridges' and roadways' assessed conditions are better than the established condition baselines.

The Required Supplementary Information includes additional information on how the State uses the modified approach for infrastructure assets and it presents the established condition standards, condition assessments, and preservation costs.

Debt Administration

At June 30, 2005, the primary government had total bonded debt outstanding of $78.6 billion. Of this amount, $47.6 billion (60.6%) represents general obligation bonds, which are backed by the full faith and credit of the State. Included in the $47.6 billion of general obligation bonds is $10.9 billion of Economic Recovery bonds that are secured by a pledge of revenues derived from dedicated sales and use taxes. The current portion of general obligation bonds outstanding is $1.8 billion and the long-term portion is $45.8 billion. The remaining $31.0 billion (39.4%) of bonded debt outstanding represents revenue bonds, which are secured solely by specified revenue sources. The current portion of revenue bonds outstanding is $1.0 billion and the long-term portion is $30.0 billion.

Table 5 presents a summary of the primary government's long-term obligations for governmental and business-type activities.

Table 5

Long-term Obligations
Year ended June 30, 2005
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Government-wide noncurrent liabilities			
General obligation bonds	$ 43,820	$ 1,963	$ 45,783
Revenue bonds	7,978	22,014	29,992
Certificates of participation and commercial paper	247	51	298
Capital lease obligations	3,688	—	3,688
Other noncurrent liabilities	10,220	2,356	12,576
Total noncurrent liabilities	**65,953**	**26,384**	**92,337**
Current portion of long-term obligations	3,256	1,657	4,913
Total long-term obligations	**$ 69,209**	**$ 28,041**	**$ 97,250**

The primary government's total long-term obligations increased during the year ended June 30, 2005. The main reason for the increase was the issuance of $3.1 billion in general obligation bonds and $2.1 billion in revenue bonds. However, the increase due to bond issuances was offset by an increase in general obligation and revenue bond retirement payments made during the year. As part of the Strategic Debt Management Plan

adopted in the 2001-02 fiscal year, the State deferred, for up to four years, the initial principal payments on new and refunding general obligation bonds issued through June 30, 2004. Some of these deferred initial principal payments became due during the year ended June 30, 2005. Also, the initial principal payment became due this year for the Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds) issued last year.

Note 10, Long-term Obligations, and Notes 11 through 16 include additional information on the State's long-term obligations.

Recent Economic Events and Future Budgets

Recent Economic Conditions

The U.S. economy continued its expansion in 2005. Gross Domestic Product (GDP) growth for the year averaged 3.5%. In August and September of 2005 the Gulf Coast of the U.S. was hit by two major hurricanes that significantly damaged the lives and property of people in that region. Oil and gas facilities were extensively damaged, significantly raising energy prices. Many feared that the nation would fall into recession. However, the economy continued to grow in the wake of the hurricanes. GDP grew 4.1% in the third quarter before slowing to 1.6% in the fourth quarter of 2005. This slowing was at least partially due to the storms. The hurricanes slowed exports and accelerated imports, as the nation replaced lost capacity at home with petroleum products and other goods from abroad.

Payroll employment growth in calendar year 2005 was approximately 1.5% for the nation and 2.0% for California. The nation added almost 2.1 million jobs and California added approximately 287,000 jobs. By the end of December 2005, the unemployment rate in California had dropped to 5.1%, compared to 5.9% in December of 2004. The national unemployment rate in December 2005 was 4.9%.

In January 2006 payroll employment in the nation grew by 193,000 jobs and in California by 18,300 jobs. The unemployment rate dropped to 4.7% in the nation and 4.9% in California. This was the lowest unemployment rate in California since March 2001. Jobs in construction, which was the leading source of employment gains for California in the prior 12 months, showed a decline in January.

California's Future Budgets

California's 2005-06 Budget Act was enacted on July 11, 2005. The total spending plan adopted for the State was $117.4 billion, including the General Fund, special funds, and bond funds. The General Fund's available resources and expenditures were projected to be $92 billion and $90 billion, respectively. A total of $5.9 billion in budget solutions was included to eliminate the $3.4 billion budget shortfall, establish a $1.3 billion year-end reserve, and prepay the $1.2 billion vehicle license fee gap loan from local governments. The budget solutions are classified into four categories: program savings, fund shifts, loans and borrowing, and revenues from improved tax compliance. Total program savings of $4.1 billion include holding Proposition 98 education funding at 2004-05 budget levels, and suspending cost-of-living adjustments for California Work Opportunity and Responsibility to Kids and also Supplemental Security Income/State Supplementary Program grants.

General Fund revenues come predominately from taxes, with personal income taxes expected to provide 51% of the revenues. California's major taxes (personal income, sales, and corporation taxes) are projected to supply approximately 94% of the General Fund's budgeted resources in the 2005-06 fiscal year.

Governor's Proposed Budget for 2006-07

The Governor released his proposed budget on January 10, 2006. The 2006-07 proposed spending plan totals $125.6 billion. This spending plan represents estimated General Fund expenditures of $97.9 billion, special fund expenditures of $25.0 billion, and bond fund expenditures of $2.7 billion. Proposed General Fund expenditures are 8.4% higher than the $90 billion expenditures estimated for the 2005-06 fiscal year.

The Governor's budget projects to end the 2006-07 fiscal year with a $613 million reserve, including $460 million in the Budget Stabilization Account. Proposition 58, passed by California's voters in November 2004, requires that, beginning in the 2006-07 fiscal year, the State transfer into the Budget Stabilization Account by September 30 of each year a specified portion of estimated general fund revenues until the account balance reaches $8 billion or 5% of the estimated General Fund revenues, whichever is greater.

In the 2006-07 *Overview of the Governor's Budget*, the Legislative Analyst's Office, California's nonpartisan fiscal and policy advisor, expresses concerns about using unexpected revenue increases from volatile revenue sources – such as business profits and capital gains – to increase spending instead of paying down outstanding obligations such as past borrowings from schools, local governments, and transportation. Given the continuing structural budget shortfall (when annual expenses exceed annual revenues) and an estimated $1.0 billion of potential unbudgeted costs, the Legislative Analyst cautions the Legislature about taking on new and on-going program commitments at this time.

Requests for Information

The State Controller's Office designed this financial report to provide interested parties with a general overview of the State of California's finances. Address questions concerning the information provided in this report or requests for additional information to the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250. This report is also available on the Controller's Office Web site at www.sco.ca.gov.

Basic Financial Statements

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Government-wide Financial Statements

Statement of Net Assets

June 30, 2005
(amounts in thousands)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Current assets:				
Cash and pooled investments	$ 20,132,043	$ 4,936,560	$ 25,068,603	$ 2,463,380
Amount on deposit with U.S. Treasury	—	1,872,214	1,872,214	—
Investments	1,026,003	462,405	1,488,408	11,437,656
Restricted assets:				
Cash and pooled investments	—	1,768,812	1,768,812	2,818
Investments	—	570,000	570,000	31,227
Due from other governments	—	62,434	62,434	—
Receivables (net)	9,546,741	443,706	9,990,447	3,062,330
Internal balances	315,184	(315,184)	—	—
Due from primary government	—	—	—	201,033
Due from other governments	8,487,290	186,977	8,674,267	845,267
Prepaid items	35,988	7,921	43,909	4,020
Inventories	90,114	21,970	112,084	124,113
Recoverable power costs (net)	—	573,000	573,000	—
Other current assets	278,072	9,968	288,040	151,513
Total current assets	39,911,435	10,600,783	50,512,218	18,323,357
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	1,934,393	1,934,393	144,203
Investments	—	89,171	89,171	37,473
Loans receivable	—	627,588	627,588	—
Investments	—	2,154,461	2,154,461	30,588,667
Net investment in direct financing leases	—	5,386,207	5,386,207	—
Receivables (net)	1,097,109	43,357	1,140,466	857,079
Loans receivable	1,896,306	3,029,435	4,925,741	5,541,969
Recoverable power costs (net)	—	7,356,000	7,356,000	—
Deferred charges	188,842	1,435,768	1,624,610	72,388
Capital assets:				
Land	14,730,050	45,782	14,775,832	598,297
State highway infrastructure	55,114,882	—	55,114,882	—
Collections – nondepreciable	19,354	—	19,354	250,445
Buildings and other depreciable property	19,687,916	7,998,397	27,686,313	23,530,232
Less: accumulated depreciation	(8,002,315)	(3,246,357)	(11,248,672)	(10,943,488)
Construction in progress	5,628,463	1,612,665	7,241,128	3,359,432
Other noncurrent assets	—	3,668	3,668	340,862
Total noncurrent assets	90,360,607	28,470,535	118,831,142	54,377,559
Total assets	**$ 130,272,042**	**$ 39,071,318**	**$ 169,343,360**	**$ 72,700,916**

The notes to the financial statements are an integral part of this statement.

	Governmental Activities	Business-type Activities	Total	Component Units
LIABILITIES				
Current liabilities:				
Accounts payable	$ 12,377,530	$ 546,592	$ 12,924,122	$ 2,059,277
Due to component units	175,380	25,653	201,033	—
Due to other governments	7,191,541	94,762	7,286,303	4,364
Dividends payable	—	—	—	3,100
Deferred revenue	1,713	51,214	52,927	670,279
Tax overpayments	4,378,724	—	4,378,724	—
Deposits	89,910	3,890	93,800	450,953
Contracts and notes payable	41,677	—	41,677	12,818
Advance collections	633,634	31,834	665,468	312,844
Interest payable	756,696	201,230	957,926	115,996
Securities lending obligations	—	—	—	3,792,663
Benefits payable	—	369,198	369,198	3,029,110
Current portion of long-term obligations	3,255,415	1,656,999	4,912,414	2,557,333
Other current liabilities	836,923	68,272	905,195	1,698,667
Total current liabilities	29,739,143	3,049,644	32,788,787	14,707,404
Noncurrent liabilities:				
Loans payable	1,011,800	—	1,011,800	9,078
Benefits payable	—	16,591	16,591	13,695,492
Lottery prizes and annuities	—	1,764,169	1,764,169	—
Compensated absences payable	1,623,426	32,444	1,655,870	249,121
Certificates of participation, commercial paper, and other borrowings	246,501	51,093	297,594	233,120
Capital lease obligations	3,687,955	—	3,687,955	1,934,900
General obligation bonds payable	43,820,067	1,963,305	45,783,372	—
Revenue bonds payable	7,977,700	22,013,523	29,991,223	11,842,941
Other noncurrent liabilities	7,585,807	542,406	8,128,213	1,617,219
Total noncurrent liabilities	65,953,256	26,383,531	92,336,787	29,581,871
Total liabilities	**95,692,399**	**29,433,175**	**125,125,574**	**44,289,275**
NET ASSETS				
Investment in capital assets, net of related debt	79,579,676	836,524	80,416,200	8,734,425
Restricted:				
Nonexpendable – endowments	—	—	—	2,724,209
Expendable:				
Endowments and gifts	—	—	—	5,726,228
Business and transportation	1,403,500	122,506	1,526,006	1,188,494
Resources	1,770,159	1,743,654	3,513,813	—
Health and human services	716,477	86,566	803,043	—
Education	935,669	475,614	1,411,283	1,407,929
General government	2,721,929	759,466	3,481,395	665,421
Unemployment programs	83,323	4,047,567	4,130,890	—
Workers' compensation liability	—	—	—	2,863,419
Total expendable	7,631,057	7,235,373	14,866,430	11,851,491
Unrestricted	(52,631,090)	1,566,246	(51,064,844)	5,101,516
Total net assets	**34,579,643**	**9,638,143**	**44,217,786**	**28,411,641**
Total liabilities and net assets	**$ 130,272,042**	**$ 39,071,318**	**$ 169,343,360**	**$ 72,700,916**

The notes to the financial statements are an integral part of this statement.

Statement of Activities

Year Ended June 30, 2005
(amounts in thousands)

FUNCTIONS/PROGRAMS	Expenses	Program Revenues: Charges for Services	Program Revenues: Operating Grants and Contributions	Program Revenues: Capital Grants and Contributions
Primary government				
Governmental activities:				
General government	$ 8,808,652	$ 4,731,371	$ 1,244,056	$ —
Education	53,152,986	2,936,693	5,867,154	—
Health and human services	62,016,344	3,280,970	31,196,152	—
Resources	4,160,949	1,934,532	219,463	—
State and consumer services	1,038,327	601,322	6,052	—
Business and transportation	7,142,209	2,541,072	2,501,651	1,090,419
Correctional programs	6,611,219	12,354	100,913	—
Tax relief	2,157,280	1,784	—	—
Interest on long-term debt	2,408,246	—	—	—
Total governmental activities	147,496,212	16,040,098	41,135,441	1,090,419
Business-type activities:				
Electric Power	5,655,000	5,655,000	—	—
Water Resources	731,393	750,282	—	—
Public Building Construction	299,900	315,718	—	—
State Lottery	3,493,984	3,512,126	—	—
Unemployment Programs	8,939,654	10,459,688	—	—
High Technology Education	33,690	36,737	—	—
Toll Facilities	20,861	66	—	—
State University Dormitory Building Maintenance and Equipment	449,080	395,396	—	—
State Water Pollution Control Revolving	14,638	55,218	—	73,182
Housing Loan	142,085	121,063	—	—
Other enterprise programs	86,612	115,901	—	—
Total business-type activities	19,866,897	21,417,195	—	73,182
Total primary government	**$ 167,363,109**	**$ 37,457,293**	**$ 41,135,441**	**$ 1,163,601**
Component units:				
University of California	$ 19,259,070	$ 12,944,815	$ 3,976,549	$ —
State Compensation Insurance Fund	7,623,551	8,456,280	—	—
California Housing Finance Agency	488,859	436,001	122,958	—
Public Employees' Benefit Fund	3,553,260	3,023,329	—	—
Nonmajor component units	1,882,325	1,219,683	466,927	—
Total component units	**$ 32,807,065**	**$ 26,080,108**	**$ 4,566,434**	**$ —**

General revenues:
- Personal income taxes
- Sales and use taxes
- Corporation taxes
- Insurance taxes
- Other taxes
- Investment and interest
- Escheat

Transfers

Nonoperating grants and gifts

Total general and other revenues and transfers

Change in net assets

Net assets, July 1, 2004

Net assets, June 30, 2005

* Restated

The notes to the financial statements are an integral part of this statement.

Net (Expenses) Revenues and Changes in Net Assets			
Primary Government			
Governmental Activities	Business-type Activities	Total	Component Units
$ (2,833,225)		$ (2,833,225)	
(44,349,139)		(44,349,139)	
(27,539,222)		(27,539,222)	
(2,006,954)		(2,006,954)	
(430,953)		(430,953)	
(1,009,067)		(1,009,067)	
(6,497,952)		(6,497,952)	
(2,155,496)		(2,155,496)	
(2,408,246)		(2,408,246)	
(89,230,254)		(89,230,254)	
	$ —	—	
	18,889	18,889	
	15,818	15,818	
	18,142	18,142	
	1,520,034	1,520,034	
	3,047	3,047	
	(20,795)	(20,795)	
	(53,684)	(53,684)	
	113,762	113,762	
	(21,022)	(21,022)	
	29,289	29,289	
	1,623,480	1,623,480	
(89,230,254)	**1,623,480**	**(87,606,774)**	
			$ (2,337,706)
			832,729
			70,100
			(529,931)
			(195,715)
			(2,160,523)
42,504,352	—	42,504,352	—
32,488,563	—	32,488,563	—
11,174,937	—	11,174,937	—
2,231,060	—	2,231,060	—
2,507,729	—	2,507,729	—
289,363	—	289,363	—
525,897	—	525,897	—
27,727	(27,727)	—	—
—	—	—	4,039,615
91,749,628	**(27,727)**	91,721,901	**4,039,615**
2,519,374	1,595,753	4,115,127	1,879,092
32,060,269 *	8,042,390	40,102,659	26,532,549 *
$ 34,579,643	**$ 9,638,143**	$ 44,217,786	**$ 28,411,641**

The notes to the financial statements are an integral part of this statement.

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Fund Financial Statements

Balance Sheet

Governmental Funds

June 30, 2005
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
ASSETS					
Cash and pooled investments	$ 8,108,829	$ 282,145	$ 2,013,104	$ 9,223,047	$ 19,627,125
Investments	—	—	—	1,026,003	1,026,003
Receivables (net)	7,773,506	6,530	396,117	1,286,861	9,463,014
Due from other funds	764,966	85	1,129,475	2,521,467	4,415,993
Due from other governments	790,391	7,617,328	1,733	66,104	8,475,556
Interfund receivables	151,979	—	628,900	2,263,668	3,044,547
Loans receivable	101,003	41,735	—	1,619,267	1,762,005
Other assets	43,028	—	92,663	108,151	243,842
Total assets	**$ 17,733,702**	**$ 7,947,823**	**$ 4,261,992**	**$ 18,114,568**	**$ 48,058,085**
LIABILITIES					
Accounts payable	$ 1,221,511	$ 1,308,016	$ 136,975	$ 2,745,086	$ 5,411,588
Due to other funds	5,255,222	4,862,075	36,449	535,901	10,689,647
Due to component units	140,274	—	—	30,322	170,596
Due to other governments	2,816,133	1,663,490	137,823	2,574,095	7,191,541
Deferred revenue	—	—	—	1,713	1,713
Interfund payables	3,280,311	—	—	642,749	3,923,060
Tax overpayments	4,371,094	—	—	7,630	4,378,724
Deposits	7,216	—	11,699	67,345	86,260
Contracts and notes payable	—	—	—	30,142	30,142
Advance collections	29,580	59,890	5,176	365,546	460,192
Interest payable	5,457	10,439	28,615	33,319	77,830
Other liabilities	420,047	16,885	219,341	601,421	1,257,694
Total liabilities	**17,546,845**	**7,920,795**	**576,078**	**7,635,269**	**33,678,987**
FUND BALANCES					
Reserved for:					
Encumbrances	540,382	—	2,302,979	3,496,628	6,339,989
Interfund receivables	151,979	—	628,900	2,263,668	3,044,547
Loans receivable	101,003	41,735	—	1,619,267	1,762,005
Continuing appropriations	803,721	—	2,321,717	2,249,471	5,374,909
Unreserved, reported in:					
General Fund	(1,410,228)	—	—	—	(1,410,228)
Special revenue funds	—	(14,707)	(1,567,682)	1,253,371	(329,018)
Capital projects funds	—	—	—	(403,106)	(403,106)
Total fund balances (deficits)	**186,857**	**27,028**	**3,685,914**	**10,479,299**	**14,379,098**
Total liabilities and fund balances	**$ 17,733,702**	**$ 7,947,823**	**$ 4,261,992**	**$ 18,114,568**	

The notes to the financial statements are an integral part of this statement.

Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets

(amounts in thousands)

Total fund balances – governmental funds		**$ 14,379,098**
Amounts reported for governmental activities in the Statement of Net Assets are different from the governmental funds Balance Sheet because:		
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.		86,762,631
Other long-term assets are not available to pay for current-period expenditures and, therefore, are not reported.		1,097,109
Internal service funds are used by management to charge the costs of certain activities, such as fleet management and management information systems, to individual funds. The assets and liabilities of the internal service funds are included in governmental activities in the Statement of Net Assets.		615,634
Deferred bond issue costs, discounts, and premiums are reported as current expenditures in the funds. However, deferred issue costs and net discounts are amortized over the life of the bonds and are included in the governmental activities in the Statement of Net Assets.		188,842
General obligation bonds totaling $46,220,283 and revenue bonds totaling $8,068,980 are not due and payable in the current period and, therefore, are not reported in the funds.		(54,289,263)
Certain long-term liabilities are not due and payable in the current period and, therefore, adjustments to these liabilities are not reported in the funds:		
Compensated absences adjustments	(1,581,475)	
Certificates of participation and commercial paper adjustments	(752,013)	
Capital lease adjustments	(3,913,473)	
Other long-term obligations	(7,927,447)	
		(14,174,408)
Net assets of governmental activities		**$ 34,579,643**

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenditures, and Changes in Fund Balances

Governmental Funds

Year Ended June 30, 2005
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
REVENUES					
Personal income taxes	$ 42,424,929	$ —	$ —	$ 170,423	$ 42,595,352
Sales and use taxes	25,782,760	—	2,403,734	4,014,748	32,201,242
Corporation taxes	11,191,937	—	—	—	11,191,937
Insurance taxes	2,231,060	—	—	—	2,231,060
Other taxes	778,172	—	—	1,704,163	2,482,335
Intergovernmental	—	41,134,952	—	1,798,429	42,933,381
Licenses and permits	42,328	—	906,203	4,005,494	4,954,025
Charges for services	127,607	—	120,627	700,913	949,147
Fees	172,059	—	—	4,521,057	4,693,116
Penalties	54,673	489	—	640,054	695,216
Investment and interest	241,824	—	44,268	290,005	576,097
Escheat	525,897	—	—	—	525,897
Other	707,684	—	92,992	2,954,750	3,755,426
Total revenues	**84,280,930**	**41,135,441**	**3,567,824**	**20,800,036**	149,784,231
EXPENDITURES					
Current:					
General government	2,259,495	1,065,042	16,104	5,170,841	8,511,482
Education	40,876,513	6,565,389	980	4,799,897	52,242,779
Health and human services	24,810,689	29,840,305	—	7,364,634	62,015,628
Resources	858,262	215,144	6	3,003,690	4,077,102
State and consumer services	493,037	6,166	—	474,263	973,466
Business and transportation	12,428	2,443,778	3,484,316	2,616,096	8,556,618
Correctional programs	6,622,819	33,124	—	2,671	6,658,614
Tax relief	949,428	—	—	1,186,830	2,136,258
Capital outlay	414,738	—	—	1,119,412	1,534,150
Debt service:					
Bond and commercial paper retirement	1,346,146	41,545	5,000	2,279,428	3,672,119
Interest and fiscal charges	1,724,313	23,589	57,820	438,042	2,243,764
Total expenditures	**80,367,868**	**40,234,082**	**3,564,226**	**28,455,804**	152,621,980
Excess (deficiency) of revenues over (under) expenditures	3,913,062	901,359	3,598	(7,655,768)	(2,837,749)
OTHER FINANCING SOURCES (USES)					
General obligation bonds and commercial paper issued	—	—	80,000	4,978,339	5,058,339
Revenue bonds issued	—	—	—	99,250	99,250
Refunding bonds issued	—	—	5,470	1,931,960	1,937,430
Payment to refunding agent	—	—	(5,470)	(1,931,960)	(1,937,430)
Capital leases	414,738	—	—	—	414,738
Transfers in	406,591	—	10,628	4,162,982	4,580,201
Transfers out	(3,006,834)	(929,990)	(52,504)	(557,464)	(4,546,792)
Total other financing sources (uses)	**(2,185,505)**	**(929,990)**	**38,124**	**8,683,107**	5,605,736
Net change in fund balances	1,727,557	(28,631)	41,722	1,027,339	2,767,987
Fund balances (deficits), July 1, 2004	(1,540,700)	55,659	3,644,192	**9,451,960** *	11,611,111
Fund balances, June 30, 2005	**$ 186,857**	**$ 27,028**	**$ 3,685,914**	**$ 10,479,299**	$ 14,379,098

* Restated

The notes to the financial statements are an integral part of this statement.

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities

(amounts in thousands)

Net change in fund balances – total governmental funds		**$ 2,767,987**
Amounts reported for governmental activities in the Statement of Activities are different from the Statement of Revenues, Expenditures, and Changes in Fund Balances of governmental funds because:		
Governmental funds report capital outlays as expenditures. However, in the Statement of Activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays exceed depreciation in the current period.		1,975,646
Revenues in the Statement of Activities that do not provide current financial resources are deferred and not reported as revenues in the funds.		203,627
Bonds and other noncurrent financing instruments provide current financial resources to governmental funds in the form of debt, which increases long-term liabilities in the Statement of Net Assets. Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the Statement of Net Assets. The following amounts represent the difference between proceeds and repayments.		
General obligation bond adjustments	(1,782,419)	
Revenue bond adjustments	32,875	
Certificates of participation and commercial paper adjustments	97,347	
		(1,652,197)
Some expenses reported in the Statement of Activities do not require the use of current financial resources and, therefore, are not reported as expenditures in governmental funds.		
Compensated absences	(97,055)	
Lease adjustments	(177,437)	
Other long-term obligations	(502,236)	
		(776,728)
Internal service funds are used by management to charge the costs of certain activities, such as fleet management and management information systems, to individual funds. The net revenue (expense) of the internal service funds is reported with governmental activities.		1,039
Change in net assets of governmental activities		**$ 2,519,374**

The notes to the financial statements are an integral part of this statement.

Statement of Net Assets

Proprietary Funds

June 30, 2005
(amounts in thousands)

	Electric Power	Water Resources
ASSETS		
Current assets:		
Cash and pooled investments	$ —	$ 226,090
Amount on deposit with U.S. Treasury	—	—
Investments	80,000	—
Restricted assets:		
Cash and pooled investments	1,387,000	—
Investments	570,000	—
Due from other governments	—	—
Receivables (net)	—	96,697
Due from other funds	26,000	3,060
Due from other governments	—	7,208
Prepaid items	—	—
Inventories	—	9,953
Recoverable power costs (net)	573,000	—
Other current assets	—	3
Total current assets	2,636,000	343,011
Noncurrent assets:		
Restricted assets:		
Cash and pooled investments	1,482,000	156,912
Investments	—	50,862
Loans receivable	—	—
Investments	—	—
Net investment in direct financing leases	—	—
Receivables	—	—
Interfund receivables	—	91,517
Loans receivable	—	28,384
Recoverable power costs (net)	7,356,000	—
Deferred charges	—	1,320,903
Capital assets:		
Land	—	—
Buildings and other depreciable property	—	4,560,047
Less: accumulated depreciation	—	(1,644,113)
Construction in progress	—	72,950
Other noncurrent assets	—	—
Total noncurrent assets	8,838,000	4,637,462
Total assets	**$ 11,474,000**	**$ 4,980,473**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ —	$ 326,645	$ 2,534,182	$ 1,849,643	**$ 4,936,560**	$ 504,927
—	—	1,872,214	—	**1,872,214**	—
—	354,997	—	27,408	**462,405**	—
262,468	—	—	119,344	**1,768,812**	—
—	—	—	—	**570,000**	—
—	—	—	62,434	**62,434**	—
127,542	152,718	143,264	59,285	**579,506**	81,255
17,539	3,675	20,199	8,391	**78,864**	307,103
—	—	93,125	86,644	**186,977**	11,734
—	6,790	—	1,131	**7,921**	35,988
—	8,199	—	3,818	**21,970**	90,114
—	—	—	—	**573,000**	—
—	—	—	9,965	**9,968**	27
407,549	853,024	4,662,984	2,228,063	**11,130,631**	1,031,148
266,692	—	—	28,789	**1,934,393**	—
—	—	—	38,309	**89,171**	—
—	—	—	627,588	**627,588**	—
—	2,032,158	—	122,303	**2,154,461**	—
5,020,898	—	—	365,309	**5,386,207**	—
—	—	43,357	—	**43,357**	—
—	—	—	9,400	**100,917**	—
—	—	—	3,001,051	**3,029,435**	—
—	—	—	—	**7,356,000**	—
65,346	21,944	—	27,575	**1,435,768**	—
—	4,923	—	40,859	**45,782**	231
—	73,625	14,203	3,350,522	**7,998,397**	1,250,088
—	(37,580)	(4,821)	(1,559,843)	**(3,246,357)**	(838,033)
1,185,720	—	—	353,995	**1,612,665**	3,433
—	—	—	3,668	**3,668**	—
6,538,656	2,095,070	52,739	6,409,525	**28,571,452**	415,719
$ 6,946,205	**$ 2,948,094**	**$ 4,715,723**	**$ 8,637,588**	**$ 39,702,083**	**$ 1,446,867**

(continued)

Statement of Net Assets (continued)

Proprietary Funds

June 30, 2005
(amounts in thousands)

	Electric Power	Water Resources
LIABILITIES		
Current liabilities:		
Accounts payable	$ 424,000	$ 48,206
Due to other funds	—	50,639
Due to component units	—	—
Due to other governments	—	73,430
Deferred revenue	—	—
Deposits	—	—
Contracts and notes payable	—	—
Advance collections	—	—
Interest payable	68,000	20,709
Benefits payable	—	—
Current portion of long-term obligations	453,000	115,420
Other current liabilities	—	—
Total current liabilities	945,000	308,404
Noncurrent liabilities:		
Interfund payables	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	—
Certificates of participation, commercial paper, and other borrowings	—	12,398
Capital lease obligations	—	—
General obligation bonds payable	—	683,715
Revenue bonds payable	10,529,000	2,369,741
Other noncurrent liabilities	—	400,784
Total noncurrent liabilities	10,529,000	3,466,638
Total liabilities	**11,474,000**	**3,775,042**
NET ASSETS		
Investment in capital assets, net of related debt	—	210,933
Restricted – Expendable:		
Construction	—	994,498
Debt service	—	—
Security for revenue bonds	—	—
Lottery	—	—
Unemployment program	—	—
Other purposes	—	—
Total expendable	—	994,498
Unrestricted	—	—
Total net assets	**—**	**1,205,431**
Total liabilities and net assets	**$ 11,474,000**	**$ 4,980,473**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ 4,692	$ 36,193	$ 7	$ 27,365	$ 540,463	$ 177,995
33,423	279,759	202,824	67,120	633,765	270,160
25,653	—	—	—	25,653	4,784
539	—	11,841	8,952	94,762	—
—	—	—	51,214	51,214	—
—	—	—	3,890	3,890	3,650
—	—	—	—	—	11,535
24,636	2,882	—	4,316	31,834	173,442
63,366	—	—	49,155	201,230	—
—	—	369,198	—	369,198	—
340,252	582,496	—	165,831	1,656,999	18,610
—	—	66,847	1,425	68,272	4,475
492,561	901,330	650,717	379,268	3,677,280	664,651
—	—	—	3,129	3,129	96,774
—	—	—	16,591	16,591	—
—	1,764,169	—	—	1,764,169	—
—	4,903	8,122	19,419	32,444	41,952
—	—	—	38,695	51,093	—
—	—	—	—	—	3,991
—	—	—	1,279,590	1,963,305	—
6,357,041	—	—	2,757,741	22,013,523	—
—	1,785	—	139,837	542,406	23,865
6,357,041	1,770,857	8,122	4,255,002	26,386,660	166,582
6,849,602	**2,672,187**	**658,839**	**4,634,270**	30,063,940	**831,233**
—	40,968	9,317	575,306	836,524	424,469
74,920	—	—	352,525	1,421,943	—
21,683	—	—	220,448	242,131	—
—	—	—	690,022	690,022	—
—	275,907	—	—	275,907	—
—	—	4,047,567	—	4,047,567	—
—	—	—	557,803	557,803	—
96,603	275,907	4,047,567	1,820,798	7,235,373	—
—	(40,968)	—	1,607,214	1,566,246	191,165
96,603	**275,907**	**4,056,884**	**4,003,318**	9,638,143	**615,634**
$ 6,946,205	**$ 2,948,094**	**$ 4,715,723**	**$ 8,637,588**	$ 39,702,083	**$ 1,446,867**

(concluded)

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets

Proprietary Funds

Year Ended June 30, 2005
(amounts in thousands)

	Electric Power	Water Resources
OPERATING REVENUES		
Unemployment and disability insurance	$ —	$ —
Lottery ticket sales	—	—
Power sales	4,714,000	104,521
Student tuition and fees	—	—
Services and sales	—	645,761
Investment and interest	—	—
Rent	—	—
Other	—	—
Total operating revenues	**4,714,000**	**750,282**
OPERATING EXPENSES		
Lottery prizes	—	—
Power purchases (net of recoverable power costs)	4,658,000	196,023
Personal services	—	183,096
Supplies	—	—
Services and charges	56,000	121,941
Depreciation	—	77,321
Distributions to beneficiaries	—	—
Interest expense	—	—
Amortization of deferred charges	—	—
Other	—	—
Total operating expenses	**4,714,000**	**578,381**
Operating income (loss)	—	171,901
NONOPERATING REVENUES (EXPENSES)		
Investment and interest income	941,000	—
Interest expense and fiscal charges	(941,000)	(152,847)
Lottery payments for education	—	—
Other	—	(165)
Total nonoperating revenues (expenses)	**—**	**(153,012)**
Income (loss) before contributions and transfers	—	18,889
Capital contributions	—	—
Transfers in	—	—
Transfers out	—	—
Change in net assets	—	18,889
Total net assets, July 1, 2004	**—**	1,186,542
Total net assets, June 30, 2005	**$ —**	**$ 1,205,431**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ —	$ —	$ 10,208,175	$ —	**$ 10,208,175**	$ —
—	3,333,621	—	—	**3,333,621**	—
—	—	—	—	**4,818,521**	—
—	—	—	372,636	**372,636**	—
—	—	147,938	88,016	**881,715**	2,078,087
12,921	—	—	166,875	**179,796**	190
302,245	—	—	56,846	**359,091**	—
552	—	—	8,607	**9,159**	—
315,718	**3,333,621**	**10,356,113**	**692,980**	**20,162,714**	**2,078,277**
—	1,795,254	—	—	**1,795,254**	—
—	—	—	—	**4,854,023**	—
—	41,913	123,242	153,414	**501,665**	650,181
—	16,103	—	—	**16,103**	9,725
13,837	335,222	66,612	197,250	**790,862**	1,319,175
—	7,107	524	84,272	**169,224**	85,690
—	—	8,749,276	—	**8,749,276**	—
279,474	—	—	196,853	**476,327**	1,058
6,589	96	—	274	**6,959**	—
—	—	—	75,778	**75,778**	—
299,900	**2,195,695**	**8,939,654**	**707,841**	**17,435,471**	**2,065,829**
15,818	1,137,926	1,416,459	(14,861)	**2,727,243**	12,448
—	177,534	103,575	31,401	**1,253,510**	3,233
—	(149,514)	—	(10,424)	**(1,253,785)**	(5)
—	(1,148,775)	—	—	**(1,148,775)**	—
—	971	—	(28,701)	**(27,895)**	(3,692)
—	**(1,119,784)**	**103,575**	**(7,724)**	**(1,176,945)**	**(464)**
15,818	18,142	1,520,034	(22,585)	**1,550,298**	11,984
—	—	—	73,182	**73,182**	—
462	—	12,180	3,408	**16,050**	—
—	—	—	(43,777)	**(43,777)**	(10,945)
16,280	18,142	1,532,214	10,228	**1,595,753**	1,039
80,323	**257,765**	**2,524,670**	**3,993,090**	**8,042,390**	**614,595**
$ 96,603	**$ 275,907**	**$ 4,056,884**	**$ 4,003,318**	**$ 9,638,143**	**$ 615,634**

The notes to the financial statements are an integral part of this statement.

Statement of Cash Flows

Proprietary Funds

Year Ended June 30, 2005
(amounts in thousands)

	Electric Power	Water Resources
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers/employers	$ 4,784,000	$ 712,327
Receipts from interfund services provided	—	—
Payments to suppliers	(5,046,000)	(312,564)
Payments to employees	—	(183,095)
Payments for interfund services used	—	—
Payments for Lottery prizes	—	—
Claims paid to other than employees	—	—
Other receipts (payments)	306,000	—
Net cash provided by (used in) operating activities	**44,000**	**216,668**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Proceeds from bonds	—	—
Retirement of general obligation bonds	—	—
Retirement of revenue bonds	(388,000)	—
Interest paid on operating debt	(480,000)	—
Transfers in	—	—
Transfers out	—	—
Grants received	—	—
Lottery payments for education	—	—
Other	847,000	(14,589)
Net cash provided by (used in) noncapital financing activities	**(21,000)**	**(14,589)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Acquisition of intangible assets	—	—
Acquisition of capital assets	—	(35,881)
Proceeds from sale of capital assets	—	—
Proceeds from notes payable and commercial paper	—	15,556
Principal paid on notes payable and commercial paper	—	(13,677)
Payment of capital lease obligations	—	—
Retirement of general obligation bonds	—	(46,320)
Proceeds from revenue bonds	—	278,647
Retirement of revenue bonds	—	(303,302)
Interest paid	—	(153,080)
Net cash provided by (used in) capital and related financing activities	**—**	**(258,057)**
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(620,000)	—
Proceeds from maturity and sale of investments	—	—
Change in interfund receivables and loans receivable	—	4,597
Earnings on investments	85,000	11,092
Net cash provided by (used in) investing activities	**(535,000)**	**15,689**
Net increase (decrease) in cash and pooled investments	(512,000)	(40,289)
Cash and pooled investments at July 1, 2004	**3,381,000**	**423,291**
Cash and pooled investments at June 30, 2005	**$ 2,869,000**	**$ 383,002**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	State Lottery	Unemployment Programs	Nonmajor Enterprise	Total	Internal Service Funds
$ 554,106	$ 3,332,789	$ 10,329,578	$ 572,347	$ 20,285,147	$ 2,029,547
—	—	—	833	833	25,967
(13,515)	(94,642)	(66,693)	(247,455)	(5,780,869)	(1,378,710)
—	(36,287)	(122,984)	(137,849)	(480,215)	(578,458)
—	(8,542)	—	(131,996)	(140,538)	(100,436)
—	(2,031,748)	—	—	(2,031,748)	—
—	(233,496)	(8,735,198)	(236)	(8,968,930)	(10,084)
(276,873)	929	83,822	(91,061)	22,817	102,150
263,718	**929,003**	**1,488,525**	**(35,417)**	2,906,497	**89,976**
—	—	—	22	22	(901)
—	—	—	162,600	162,600	—
—	—	—	(220,800)	(220,800)	—
—	—	—	(90,970)	(478,970)	—
—	—	—	(12,117)	(492,117)	(5)
462	—	12,180	3,987	16,629	—
—	—	—	(20,150)	(20,150)	(10,946)
—	—	—	72,068	72,068	—
—	(1,134,756)	—	—	(1,134,756)	—
—	—	—	(28,863)	803,548	(3,382)
462	**(1,134,756)**	**12,180**	**(134,223)**	(1,291,926)	**(15,234)**
11,451	—	—	—	11,451	—
—	—	—	—	—	(2,463)
(720,396)	(10,974)	(4,801)	(381,657)	(1,153,709)	(38,120)
—	39	100	21	160	500
—	—	—	—	15,556	—
—	—	—	—	(13,677)	(2,971)
—	—	—	—	—	(2,930)
—	—	—	—	(46,320)	—
955,860	—	—	595,655	1,830,162	—
(290,210)	—	—	(85,025)	(678,537)	—
—	—	—	—	(153,080)	(1,058)
(43,295)	**(10,935)**	**(4,701)**	**128,994**	(187,994)	**(47,042)**
—	(92,847)	(464,689)	—	(1,177,536)	—
—	360,862	—	46,259	407,121	—
—	—	—	—	4,597	—
—	7,927	103,576	28,351	235,946	3,309
—	**275,942**	**(361,113)**	**74,610**	(529,872)	**3,309**
220,885	59,254	1,134,891	33,964	896,705	31,009
308,275	**267,391**	**1,399,291**	**1,963,812**	7,743,060	**473,918**
$ 529,160	**$ 326,645**	**$ 2,534,182**	**$ 1,997,776**	$ 8,639,765	**$ 504,927**

(continued)

Statement of Cash Flows (continued)

Proprietary Funds

Year Ended June 30, 2005
(amounts in thousands)

	Electric Power	Water Resources
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Operating income (loss)	$ —	$ 171,901
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:		
Interest expense on operating debt	—	—
Depreciation	—	77,321
Accretion of capital appreciation bonds	—	—
Provisions and allowances	—	—
Accrual of deferred charges	—	—
Amortization of discounts	—	—
Amortization of deferred charges	—	(20,559)
Other	—	—
Change in assets and liabilities:		
Receivables	—	(10,048)
Due from other funds	—	—
Due from other governments	—	—
Prepaid items	—	—
Inventories	—	274
Net investment in direct financing leases	—	—
Recoverable power costs (net)	72,000	—
Other current assets	—	833
Loans receivable	—	—
Interfund receivable	—	—
Accounts payable	(28,000)	9,081
Due to other funds	—	15,998
Due to component units	—	—
Due to other governments	—	(29,088)
Deposits	—	—
Advance collections	—	—
Interest payable	—	—
Other current liabilities	—	—
Interfund payables	—	—
Deferred revenue	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	955
Other noncurrent liabilities	—	—
Total adjustments	44,000	44,767
Net cash provided by (used in) operating activities	**$ 44,000**	**$ 216,668**
Noncash capital and related financing and investing activities		
Interest accreted on annuitized prizes	$ —	$ —
Unclaimed Lottery prizes directly transferred to Education Fund	—	—
Unrealized gain on investment	—	—

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	State Lottery	Unemployment Programs	Nonmajor Enterprise	Total	Internal Service Funds
$ 15,818	$ 1,137,926	$ 1,416,459	$ (14,861)	**$ 2,727,243**	$ 12,448
—	—	—	—	**—**	1,058
—	7,107	524	84,272	**169,224**	85,690
2,536	—	—	3,613	**6,149**	—
—	1,891	—	(416)	**1,475**	—
(8,015)	—	—	(11,673)	**(19,688)**	—
(5,815)	—	—	—	**(5,815)**	—
6,589	96	—	154	**(13,720)**	—
(1,020)	1,906	—	1,510	**2,396**	3,410
—	(3,499)	6,164	(11,895)	**(19,278)**	(43,761)
(11,317)	397	(10,844)	(2,881)	**(24,645)**	(6,707)
—	—	(35,869)	(1,041)	**(36,910)**	(10,771)
—	—	—	230	**230**	(6,457)
—	58	—	(109)	**223**	8,068
261,269	—	—	24,638	**285,907**	—
—	—	—	—	**72,000**	—
—	5,694	—	1,909	**8,436**	1,445
—	—	—	(35,734)	**(35,734)**	—
—	—	—	43	**43**	—
1,046	13,337	7	(8,703)	**(13,232)**	(13,031)
279	145	96,807	(30,153)	**83,076**	77,321
—	—	—	—	**—**	2,756
2,070	—	(1,123)	(2,647)	**(30,788)**	(311)
—	(4)	—	(721)	**(725)**	2,075
(46)	—	—	(9,699)	**(9,745)**	(41,977)
324	—	—	2,384	**2,708**	—
—	777	952	(18,679)	**(16,950)**	7,088
—	—	—	(243)	**(243)**	—
—	—	—	12,283	**12,283**	—
—	(334)	15,191	(2,858)	**11,999**	—
—	(236,494)	—	—	**(236,494)**	—
—	—	257	(103)	**1,109**	11,111
—	—	—	(14,037)	**(14,037)**	521
247,900	(208,923)	72,066	(20,556)	**179,254**	77,528
$ 263,718	**$ 929,003**	**$ 1,488,525**	**$ (35,417)**	**$ 2,906,497**	**$ 89,976**
					(concluded)
$ —	$ 149,515	$ —	$ —	**$ 149,515**	$ —
—	27,019	—	—	**27,019**	—
—	18,142	—	—	**18,142**	—

The notes to the financial statements are an integral part of this statement.

Statement of Fiduciary Net Assets

Fiduciary Funds and Similar Component Units

June 30, 2005
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment	Agency
ASSETS				
Cash and pooled investments	$ 22,444	$ 1,600,961	$ 18,662,977	$ 4,059,624
Investments, at fair value:				
Short-term	—	5,649,059	—	—
Equity securities	—	227,060,642	—	—
Debt securities	—	105,963,056	—	—
Real estate	—	18,204,480	—	—
Other	1,721,860	24,746,264	—	—
Securities lending collateral	—	69,652,234	—	—
Total investments	1,721,860	451,275,735	—	—
Receivables (net)	2,653	12,362,985	43,059	676,047
Due from other funds	64,096	438,038	—	6,292,183
Due from other governments	—	—	—	14,726
Prepaid Items	—	—	—	17,946
Interfund receivables	1,011,800	—	—	—
Loans receivable	—	—	—	145,429
Other assets	99,995	2,784,569	—	362
Total assets	**2,922,848**	**468,462,288**	**18,706,036**	**$ 11,206,317**
LIABILITIES				
Accounts payable	7,573	9,051,667	36	$ 3,768,146
Due to other funds	64	2,355	286	—
Due to other governments	—	624	133,901	5,824,880
Tax overpayments	—	—	—	229
Benefits payable	—	1,428,282	—	—
Deposits	99,995	—	—	737,950
Advance collections	—	—	—	101,182
Securities lending obligations	—	69,649,742	—	—
Interfund payables	—	—	—	134,301
Other liabilities	1,091,716	9,251,993	—	639,629
Total liabilities	**1,199,348**	**89,384,663**	**134,223**	**$ 11,206,317**
NET ASSETS				
Held in trust for pension benefits, pool participants, and other purposes	**$ 1,723,500**	**$ 379,077,625**	**$ 18,571,813**	

The notes to the financial statements are an integral part of this statement.

Statement of Changes in Fiduciary Net Assets

Fiduciary Funds and Similar Component Units

Year Ended June 30, 2005
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment
ADDITIONS			
Contributions:			
Employer	$ —	$ 9,321,959	$ —
Plan member	—	6,810,668	—
Total contributions	—	16,132,627	—
Investment income:			
Net appreciation in fair value of investments	—	29,617,995	—
Interest, dividends, and other investment income	49,376	14,996,717	431,339
Less: investment expense	—	(3,514,948)	—
Net investment income	49,376	41,099,764	431,339
Receipts from depositors	364,418	—	22,523,859
Transfers in	4,229	1,034	—
Other	40,757	4,578	—
Total additions	**458,780**	**57,238,003**	**22,955,198**
DEDUCTIONS			
Distributions paid and payable to participants	—	15,818,451	429,731
Refunds of contributions	—	885,920	—
Administrative expense	7,569	348,309	1,608
Payments to and for depositors	148,139	347,057	25,902,751
Total deductions	**155,708**	**17,399,737**	**26,334,090**
Change in net assets	303,072	39,838,266	(3,378,892)
Net assets, July 1, 2004	**1,420,428**	**339,239,359**	**21,950,705**
Net assets, June 30, 2005	**$ 1,723,500**	**$ 379,077,625**	**$ 18,571,813**

The notes to the financial statements are an integral part of this statement.

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Discretely Presented Component Units Financial Statements

Statement of Net Assets

Discretely Presented Component Units – Enterprise Activity

June 30, 2005
(amounts in thousands)

	University of California	State Compensation Insurance	California Housing Finance Agency	Public Employees' Benefits	Nonmajor Component Units	Total
ASSETS						
Current assets:						
Cash and pooled investments	$ 244,126	$ 306,211	$ 740,754	$ 486,178	$ 686,111	$ 2,463,380
Investments	6,369,050	2,240,563	2,613,536	27,495	187,012	11,437,656
Restricted assets:						
Cash and pooled investments	—	—	—	—	2,818	2,818
Investments	—	—	—	—	31,227	31,227
Receivables (net)	1,394,064	1,042,964	342,793	1,599	280,910	3,062,330
Due from primary government	196,232	—	—	3,627	1,174	201,033
Due from other governments	675,499	—	—	118,082	51,686	845,267
Prepaid items	—	2,355	651	—	1,014	4,020
Inventories	123,829	—	—	—	284	124,113
Other current assets	98,498	457	76	—	52,482	151,513
Total current assets	9,101,298	3,592,550	3,697,810	636,981	1,294,718	18,323,357
Noncurrent assets:						
Restricted assets:						
Cash and pooled investments	—	—	—	—	144,203	144,203
Investments	—	—	—	—	37,473	37,473
Investments	12,470,409	15,561,973	51,707	1,667,658	836,920	30,588,667
Receivables (net)	667,879	13,500	—	—	175,700	857,079
Loans receivable	—	—	5,296,855	—	245,114	5,541,969
Deferred charges	—	39,309	31,474	—	1,605	72,388
Capital assets:						
Land	489,685	25,680	—	—	82,932	598,297
Collections – nondepreciable	245,578	—	—	—	4,867	250,445
Buildings and other depreciable property	21,736,142	385,649	1,541	—	1,406,900	23,530,232
Less: accumulated depreciation	(10,252,600)	(169,740)	(635)	—	(520,513)	(10,943,488)
Construction in progress	3,311,500	—	—	—	47,932	3,359,432
Other noncurrent assets	240,700	—	15,428	—	84,734	340,862
Total noncurrent assets	28,909,293	15,856,371	5,396,370	1,667,658	2,547,867	54,377,559
Total assets	**$ 38,010,591**	**$ 19,448,921**	**$ 9,094,180**	**$ 2,304,639**	**$ 3,842,585**	**$ 72,700,916**

The notes to the financial statements are an integral part of this statement.

	University of California	State Compensation Insurance	California Housing Finance Agency	Public Employees' Benefits	Nonmajor Component Units	Total
LIABILITIES						
Current liabilities:						
Accounts payable	$ 1,496,607	$ 172,605	$ 45,885	$ 244,760	$ 99,420	$ 2,059,277
Due to other governments	—	—	682	—	3,682	4,364
Deposits	297,691	—	152,100	—	1,162	450,953
Dividends payable	—	3,100	—	—	—	3,100
Deferred revenue	612,923	—	—	—	57,356	670,279
Contracts and notes payable	—	—	—	—	12,818	12,818
Advance collections	—	312,065	—	—	779	312,844
Interest payable	—	—	114,835	—	1,161	115,996
Benefits payable	—	3,029,110	—	—	—	3,029,110
Securities lending obligations	2,865,445	927,218	—	—	—	3,792,663
Current portion of long-term obligations	1,164,636	—	1,098,577	220,478	73,642	2,557,333
Other current liabilities	1,251,551	161,709	735	113,313	171,359	1,698,667
Total current liabilities	7,688,853	4,605,807	1,412,814	578,551	421,379	14,707,404
Noncurrent liabilities:						
Benefits payable	—	11,450,780	—	2,244,712	—	13,695,492
Compensated absences payable	185,965	52,814	—	—	10,342	249,121
Loans payable	—	—	—	—	9,078	9,078
Certificates of participation, commercial paper, and other borrowings	222,111	—	—	—	11,009	233,120
Capital lease obligations	1,779,604	—	—	—	155,296	1,934,900
Revenue bonds payable	4,943,557	—	6,404,308	—	495,076	11,842,941
Other noncurrent liabilities	962,942	234,512	87,658	—	332,107	1,617,219
Total noncurrent liabilities	8,094,179	11,738,106	6,491,966	2,244,712	1,012,908	29,581,871
Total liabilities	**15,783,032**	**16,343,913**	**7,904,780**	**2,823,263**	**1,434,287**	44,289,275
NET ASSETS						
Investment in capital assets, net of related debt	8,108,355	241,589	906	—	383,575	8,734,425
Restricted:						
Nonexpendable	2,183,735	—	—	—	540,474	2,724,209
Expendable:						
Endowments and gifts	5,720,300	—	—	—	5,928	5,726,228
Education	707,831	—	—	—	540,531	1,248,362
Indenture	—	—	721,750	—	—	721,750
Employee benefits	—	—	—	303,807	—	303,807
Workers' compensation liability	—	2,863,419	—	—	—	2,863,419
Statute	—	—	466,744	—	213,032	679,776
Other purposes	—	—	—	—	308,149	308,149
Total expendable	6,428,131	2,863,419	1,188,494	303,807	1,067,640	11,851,491
Unrestricted	5,507,338	—	—	(822,431)	416,609	5,101,516
Total net assets	**22,227,559**	**3,105,008**	**1,189,400**	**(518,624)**	**2,408,298**	28,411,641
Total liabilities and net assets	**$ 38,010,591**	**$ 19,448,921**	**$ 9,094,180**	**$ 2,304,639**	**$ 3,842,585**	$ 72,700,916

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets

Discretely Presented Component Units – Enterprise Activity

Year Ended June 30, 2005
(amounts in thousands)

	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Public Employees' Benefits	Nonmajor Component Units	Total
OPERATING REVENUES						
Student tuition and fees	$ 1,557,828	$ —	$ —	$ —	$ 116,230	$ 1,674,058
Grants and contracts	3,976,549	—	48,835	—	466,927	4,492,311
Services and sales	5,872,193	—	7,994	2,884,225	876,140	9,640,552
Department of Energy laboratories	4,146,261	—	—	—	—	4,146,261
Earned premiums (net)	—	7,918,319	—	—	—	7,918,319
Investment and interest	—	—	300,330	—	14,373	314,703
Rent	—	—	—	—	22,067	22,067
Other	383,729	20,003	7,508	1,721	96,005	508,966
Total operating revenues	**15,936,560**	**7,938,322**	**364,667**	**2,885,946**	**1,591,742**	**28,717,237**
OPERATING EXPENSES						
Personal services	8,923,998	578,870	18,944	—	253,913	9,775,725
Scholarships and fellowships	363,161	—	—	—	23,654	386,815
Supplies	1,706,728	—	—	—	5,662	1,712,390
Services and charges	310,620	61,286	67,888	3,553,260	617,026	4,610,080
Department of Energy laboratories	4,112,077	—	—	—	—	4,112,077
Depreciation	954,878	19,253	168	—	60,246	1,034,545
Distributions to beneficiaries	—	5,979,711	—	—	—	5,979,711
Interest expense	—	—	326,345	—	5,141	331,486
Amortization of deferred charges	—	853,687	1,391	—	59	855,137
Other	2,248,781	130,744	—	—	664,034	3,043,559
Total operating expenses	**18,620,243**	**7,623,551**	**414,736**	**3,553,260**	**1,629,735**	**31,841,525**
Operating income (loss)	(2,683,683)	314,771	(50,069)	(667,314)	(37,993)	(3,124,288)
NONOPERATING REVENUES (EXPENSES)						
Primary government and federal grants	2,583,742	—	74,123	—	—	2,657,865
Donations and Grants	—	—	—	—	8,246	8,246
Grants provided	(343,388)	—	(74,123)	—	(146,500)	(564,011)
Private gifts	869,469	—	—	—	131,356	1,000,825
Investment and interest income	837,687	514,026	120,169	137,383	94,868	1,704,133
Interest expense and fiscal charges	(295,439)	—	—	—	(27,660)	(323,099)
Other	147,117	3,932	—	—	(78,430)	72,619
Total nonoperating revenues	**3,799,188**	**517,958**	**120,169**	**137,383**	**(18,120)**	**4,556,578**
Income (loss) before contributions	1,115,505	832,729	70,100	(529,931)	(56,113)	1,432,290
Capital contributions	217,218	—	—	—	15,324	232,542
Permanent endowments	170,090	—	—	—	44,170	214,260
Change in net assets	1,502,813	832,729	70,100	(529,931)	3,381	1,879,092
Total net assets, July 1, 2004	**20,724,746 ***	**2,272,279**	**1,119,300**	**11,307**	**2,404,917 ***	**26,532,549**
Total net assets, June 30, 2005	**$ 22,227,559**	**$ 3,105,008**	**$ 1,189,400**	**$ (518,624)**	**$ 2,408,298**	**$ 28,411,641**

* Restated

The notes to the financial statements are an integral part of this statement.

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Notes to the Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present information on the financial activities of the State of California over which the Governor, the Legislature, and other elected officials have direct or indirect governing and fiscal control. These financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The provisions of the following Governmental Accounting Standards Board (GASB) Statement have been implemented for the year ended June 30, 2005:

GASB Statement No. 40, *Deposit and Investment Risk Disclosures, an Amendment of GASB Statement No. 3.*

This new GASB Statement significantly changed the disclosure of risks related to the State's investments as shown in Note 3, Deposits and Investments.

A. Reporting Entity

These financial statements present the primary government of the State and its component units. The **primary government** consists of all funds, organizations, institutions, agencies, departments, and offices that are not legally separate from the State. **Component units** are organizations that are legally separate from the State but for which the State is financially accountable or organizations whose relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The decision to include a component unit in the State's reporting entity is based on several criteria, including legal standing, fiscal dependency, and financial accountability. Following is information on the blended, fiduciary, and discretely presented component units of the State.

1. Blended Component Units

Blended components units, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from these blended component units are integrated into the appropriate funds for reporting purposes.

Building authorities are blended component units because they have been created through the use of joint exercise-of-powers agreements with various cities to finance the construction of state buildings. The building authorities are reported as capital projects funds. As a result, capital lease arrangements between the building authorities and the State in the amount of $683 million have been eliminated from the financial statements. Instead, only the underlying capital assets and the debt used to acquire them are reported in the government-wide financial statements. For information on how to obtain copies of the financial statements of the building authorities, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

The *Golden State Tobacco Securitization Corporation (GSTSC)* is a not-for-profit corporation established through legislation in September 2002 solely for the purpose of purchasing Tobacco Settlement Revenues from the State. The five voting members of the State Public Works Board serve ex officio as the directors of the corporation. GSTSC is authorized to issue bonds necessary to provide sufficient funds for carrying out its purpose. GSTSC is reported in the combining statements in the Nonmajor Governmental Funds section as a special revenue fund. For information on how to obtain copies of the financial statements of GSTSC, contact the Department of Finance, Capital Outlay/Resources Section, 915 L Street, 9th Floor, Sacramento, California 94250.

The *California State University, Channel Islands Site Authority (Site Authority)* was formed in 1998 to convert the property previously known as the Camarillo State Hospital from its former use to a California State University campus and other compatible uses. The Site Authority is governed by a board of seven members comprised of four representatives of the Trustees of the California State University and three representatives from Ventura County. The *California State University, Channel Islands Financing Authority (Financing Authority)* was formed in 2000 to provide financing through revenue bonds for the construction and other improvements conducted by the Site Authority. The Site Authority and the Financing Authority are included in the California State University Programs special revenue fund in the combining statements in the Nonmajor Governmental Funds section. The loan and other transactions of $197.7 million between the two authorities have been eliminated from the financial statements. Instead, only the underlying capital assets and the debt used to acquire them are reported in the government-wide financial statements. For information on how to obtain copies of the financial statements of the Site Authority and the Financing Authority, contact the California State University, Channel Islands, One University Drive, Camarillo, California 93012.

2. Fiduciary Component Units

The State has three fiduciary component units that administer pension and other employee benefit trust funds. These entities are legally separate from the State and meet the definition of a component unit because they are fiscally dependent on the State; however, due to their fiduciary nature, they are presented in the Fiduciary Fund Statements as pension and other employee benefit trust funds, along with other primary government fiduciary funds.

The *California Public Employees' Retirement System (CalPERS)* administers pension and health benefit plans for state employees, non-teaching school employees, and employees of California public agencies. Its Board of Administration has plenary authority and fiduciary responsibility for the investment of monies and the administration of the plans. CalPERS administers the following seven pension and other employee benefit trust funds: the Public Employees' Retirement Fund, the Judges' Retirement Fund, the Judges' Retirement Fund II, the Legislators' Retirement Fund, the Volunteer Firefighters' Length of Service Award Fund, the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, and the Supplemental Contributions Program Fund. Copies of CalPERS' separately issued financial statements may be obtained in writing from the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229.

The *California State Teachers' Retirement System (CalSTRS)* administers pension benefit plans for California public school teachers and certain other employees of the public school system. CalSTRS administers two pension and other employee benefit trust funds: the State Teachers' Retirement Fund and the Teachers' Health Benefits Fund. Copies of CalSTRS' separately issued financial statements may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851.

The *University of California Retirement System (UCRS)* is part of the comprehensive benefits package that offers defined benefit plans and defined contribution plans to employees of the university. The UCRS is a fiduciary activity of the University of California, a discretely presented component unit. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607.

3. Discretely Presented Component Units

Enterprise activity of discretely presented component units is reported in a separate column in the government-wide financial statements. Discretely presented component units are legally separate from the primary government and mostly provide services to entities and individuals outside the primary government. Discretely presented component units that report enterprise activity include the University of California, the State Compensation Insurance Fund, the California Housing Finance Agency, the Public Employees' Benefits Fund, and nonmajor component units.

The *University of California* was founded in 1868 as a public, state-supported, land grant institution. It was written into the State Constitution of 1879 as a public trust to be administered by a governing board, the Regents of the University of California. The University of California is a component unit of the State because the State appoints a voting majority of the regents and because expenditures for the support of various university programs and capital outlay are appropriated by the annual Budget Act. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607.

The *State Compensation Insurance Fund (SCIF)* is a self-supporting enterprise created to offer insurance protection to employers at the lowest possible cost. It operates in competition with other insurance carriers to provide services to the State, counties, cities, school districts, and other public corporations. It is a component unit of the State because the State appoints all five voting members of SCIF's governing board and has the authority to approve or modify SCIF's budget. Copies of SCIF's financial statements for the year ended December 31, 2004, may be obtained from the State Compensation Insurance Fund, 1275 Market Street, San Francisco, California 94103.

The *California Housing Finance Agency (CalHFA)* was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act, as amended. CalHFA's purpose is to meet the housing needs of persons and families of low and moderate income. It is a component unit of the State because the State appoints a voting majority of CalHFA's governing board and has the authority to approve or modify its budget. Copies of CalHFA's financial statements may be obtained from the California Housing Finance Agency, P.O. Box 4034, Sacramento, California 95812.

The *Public Employees' Benefits Fund*, which is administered by the California Public Employees' Retirement System and accounts for contributions and premiums for public employee long-term care plans and for administration of a deferred compensation program. Copies of CalPERS' separately issued financial statements may be obtained in writing from the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229.

State legislation created various *nonmajor component units* to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of financing for programs deemed to be in the public interest. The California Pollution Control Financing Authority, the San Joaquin River Conservancy, and the district agricultural associations are considered component units since they have a fiscal dependency on the primary government. The California Educational Facilities Authority is considered a component unit because its exclusion from the statements would be misleading because of its relationship to the primary government. California State University auxiliary organizations are considered component units because they exist entirely or almost entirely for the direct benefit of the universities. The remaining nonmajor component units are considered component units because the majority of members of their governing boards are appointed by or are members of the primary government, the primary government can impose its will on the entity, or the entity provides a specific financial benefit to the primary government. For information on how to obtain copies of the financial statements of these component units, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

The nonmajor component units are:

The *California Alternative Energy and Advanced Transportation Financing Authority*, which provides financing for alternative energy and advanced transportation technologies;

The *California Infrastructure and Economic Development Bank*, which provides financing for business development and public improvements;

The *California Pollution Control Financing Authority*, which provides financing for pollution control facilities;

The *California Health Facilities Financing Authority*, which provides financing for the construction, equipping, and acquisition of health facilities;

The *California Educational Facilities Authority*, which issues revenue bonds to finance loans for students attending public and private colleges and universities and to assist private educational institutions of higher learning in financing the expansion and construction of educational facilities;

The *California School Finance Authority*, which provides loans to school and community college districts to assist them in obtaining equipment and facilities;

California State University auxiliary organizations, which provide services primarily to university students through foundations, associated student organizations, student unions, food service entities, book stores, and similar organizations;

District agricultural associations, which exhibit all of the industries, industrial enterprises, resources, and products of the state (the district agricultural association's financial report is as of and for the year ended December 31, 2004);

The *University of California Hastings College of the Law*, which was established as the law department of the University of California to provide legal education programs and operates independently under its own board of directors. The college has a discretely presented component unit, the Foundation, that provides private sources of funds for academic programs, scholarships, and faculty research;

The *San Joaquin River Conservancy*, which was created to acquire and manage public lands within the San Joaquin River Parkway;

The *California Urban Waterfront Area Restoration Financing Authority*, which provides financing for coastal and inland urban waterfront restoration projects; and

The *California Consumer Power and Conservation Financing Authority*, which provides financing for projects to increase power supplies, reduce demand for energy, and improve the efficiency and environmental performance of power plants.

4. Joint Venture

A joint venture is an entity resulting from a contractual arrangement; it is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control. In such an arrangement, the participants retain an ongoing financial interest or an ongoing financial responsibility in the entity. These entities are not part of the primary government or a component unit.

The State participates in a joint venture with the *Capitol Area Development Authority (CADA)*. CADA was created in 1978 by the joint exercise of powers agreement between the primary government and the City of Sacramento for the location of state buildings and other improvements. CADA is a public entity, separate from the primary government and the city, and is administered by a board of five members: two appointed by the primary government, two appointed by the city, and one appointed by the affirmative vote of at least three of the other four members of the board. The primary government designates the chairperson of the board. Although the primary government does not have an equity interest in CADA, it does have an ongoing financial interest. Based upon the appointment authority, the primary government has the ability to indirectly influence CADA to undertake special projects for the citizenry of the participants. The primary government subsidizes CADA's operations by leasing land to CADA without consideration; however, the primary government is not obligated to do so. At June 30, 2005, CADA had total assets of $26.0 million, total liabilities of $18.0 million, and total net assets of $8.0 million. Total revenues for the fiscal year were $8.5 million and expenses were $7.7 million, resulting in a net income of $753,792. Because the primary government does not have an equity interest in CADA, CADA's financial information is not included in the financial statements of this report. Separately issued financial statements may be obtained from the Capitol Area Development Authority, 1522 14th Street, Sacramento, California 95814.

5. Related Organizations

A related organization is an organization for which a primary government is accountable because that government appoints a voting majority of the organization's governing board, but for which it is not financially accountable.

Chapter 854 of the Statutes of 1996 created an *Independent System Operator*, a state-chartered, nonprofit market institution. The Independent System Operator is responsible for providing centralized control of the statewide electrical transmission grid to ensure the efficient use and reliable operation of the transmission system. A five-member oversight board, comprised of three Governor appointees, an appointee of the Senate Committee on Rules, and an appointee of the Speaker of the Assembly, oversees the Independent System Operator and appoints a governing board that is broadly representative of the state's electricity users and providers. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the Independent System Operator, the financial information of this institution is not included in the financial statements of this report. For information on how to obtain copies of the financial statements of the Independent System Operator, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, CA 94250.

The *California Earthquake Authority (CEA)*, a legally separate organization, offers basic earthquake insurance for California homeowners, renters, condominium owners, and mobilehome owners. A three-member board of state-elected officials governs the CEA. The State's accountablility for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the CEA, the financial information of this institution is not included in the financial statements of this report. For information on how to obtain copies of the financial statements of the CEA, contact the California Earthquake Authority, 801 K Street, Suite 1000, Sacramento, CA 95814.

The *Bay Area Toll Authority*, which is not part of the State's reporting entity, was created by the California Legislature in 1997 to administer the base $2 toll on toll revenues collected from the San Francisco Bay Area's seven state-owned toll bridges and to have program oversight related to certain bridge construction projects. Additional information on the Bay Area Toll Authority may be obtained from the Metropolitan Transportation Commission, 101 Eighth Street, Oakland, California 94607.

B. Government-wide and Fund Financial Statements

Government-wide financial statements (the Statement of Net Assets and the Statement of Activities) report information on all the nonfiduciary activities of the primary government and its component units. The primary government is reported separately from legally separate component units for which the State is financially accountable. Within the primary government, the State's governmental activities, which are normally supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. The effect of interfund activity has been removed from the statements, with the exception of amounts between governmental and business-type activities, which are presented as internal balances and transfers. Centralized services provided by the General Fund for other funds are charged as direct costs to the funds that received those services. Also, the General Fund recovers from the federal government the cost of centralized services provided to federal programs.

The Statement of Net Assets reports all of the financial and capital resources of the government as a whole in a format where assets equal liabilities plus net assets. The statement of activities demonstrates the degree to which the expenses of a given function are offset by program revenues. Program revenues include charges to customers who purchase, use, or directly benefit from goods, services, or privileges provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items that are not program-related are reported as general revenues.

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. A fund is a fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds is maintained that is consistent with legal and managerial requirements. Fiduciary funds, although excluded from the government-wide statements, are included in the fund financial statements. Major governmental and enterprise funds are reported in separate columns in the fund financial statements. Nonmajor governmental and proprietary funds are grouped into separate columns. Discretely presented component unit statements, which follow the fiduciary fund statements, also separately report the enterprise activity of the major discretely presented component units. The enterprise activity of nonmajor discretely presented component units is grouped in a separate column.

Governmental fund types are used primarily to account for services provided to the general public without direct charge.

The State reports the following major governmental funds.

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.

The *Federal Fund* accounts for the receipt and use of grants, entitlements, and shared revenues received from the federal government.

The *Transportation Construction Fund* accounts for gasoline taxes, bond proceeds, and other revenues that are used for highway and passenger rail construction.

Proprietary fund types focus on the determination of operating income, changes in net assets, financial position, and cash flows.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

For its proprietary funds, the State applies all applicable GASB pronouncements. In addition, the State applies all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Committee on Accounting Procedure (CAP) Accounting Research Bulletins issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements. The State has elected not to apply FASB pronouncements issued after November 30, 1989, for its enterprise funds.

The State has two proprietary fund types: enterprise funds and internal service funds.

Enterprise funds record business-type activity for which a fee is charged to external users for goods and services. In addition, the State is required to report activities as enterprise funds in the context of the activity's principal revenue sources when any of the following criteria are met:

1. The activity's debt is secured solely by fees and charges of the activity;
2. There is a legal requirement to recover costs; or
3. The pricing policies of fees and charges are designed to recover costs.

The State reports the following *major enterprise funds*.

The *Electric Power Fund* accounts for the acquisition and resale of electric power to retail end-use customers.

The *Water Resources Fund* accounts for charges to local water districts and the sale of excess power to public utilities.

The *Public Building Construction Fund* accounts for rental charges from the lease of public assets.

The *State Lottery Fund* accounts for the sale of California State Lottery (Lottery) tickets and the Lottery's payments for education.

The *Unemployment Programs Fund* accounts for employer and worker contributions used for payments of unemployment insurance and disability benefits.

Nonmajor enterprise funds account for additional operations that are financed and operated in a manner similar to private business enterprises.

Additionally, the State reports *internal service funds* as a proprietary fund type with governmental activity. Internal service funds account for goods or services provided to other agencies, departments, or governments on a cost-reimbursement basis. The goods and services provided include: architectural services, construction and improvements, printing and procurement services, goods produced by inmates of state prisons, data processing services, administrative services related to water delivery, and equipment used by the California Department of Transportation. Internal service funds are included in the governmental activities at the government-wide level.

Fiduciary fund types are used to account for assets held by the State. The State acts as a trustee or as an agent for individuals, private organizations, other governments, or other funds. Fiduciary funds, including fiduciary component units, are not included in the government-wide financial statements.

The State has the following four fiduciary fund types.

Private purpose trust funds account for all trust arrangements, other than those properly reported in pension or investment trust funds, whereby principal and income benefit individuals, private organizations, or other governments.

Pension and other employee benefit trust funds of the primary government and fiduciary component units account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems and for other employee benefit programs.

An *investment trust fund* accounts for the deposits, withdrawals, and earnings of the Local Agency Investment Fund, an external investment pool for local governments and public agencies.

Agency funds account for assets held by the State, which acts as an agent for individuals, private organizations, or other governments.

Discretely presented component units consist of certain organizations that have enterprise activity. The enterprise activity component units are the University of California, the State Compensation Insurance Fund, the California Housing Finance Agency, the Public Employees' Benefits Fund, and nonmajor component units. All of the enterprise activity of the discretely presented component units is reported in a separate column in the government-wide financial statements and on separate pages following the fund financial statements.

C. Measurement Focus and Basis of Accounting

1. Government-wide Financial Statements

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar transactions are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

2. Fund Financial Statements

The measurement focus and basis of accounting for the fund financial statements vary with the type of fund. **Governmental fund types** are presented using the current financial resources measurement focus. With this measurement focus, operating statements present increases and decreases in net current assets; the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental 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. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments. Other revenue sources are recorded when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months.

Agency funds are custodial in nature and do not measure the results of operations. Assets and liabilities are recorded using the modified accrual basis of accounting.

Proprietary fund types, the **investment trust fund, private purpose trust funds,** and **pension and other employee benefit trust funds** are accounted for using the economic resources measurement focus.

The accounts of the proprietary fund types, the investment trust fund, private purpose trust funds, and pension and other employee benefit trust funds are reported using the accrual basis of accounting. Under the accrual basis, most transactions are recorded when they occur, regardless of when cash is received or disbursed.

Lottery revenue and the related prize expenses are recognized when sales are made. Certain prizes are payable in deferred installments. Such liabilities are recorded at the present value of amounts payable in the future.

For purposes of the Statement of Cash Flows, all cash and pooled investments in the State Treasurer's pooled investment program are considered to be cash and cash equivalents.

Discretely presented component units are accounted for using the economic resources measurement focus and the accrual basis of accounting.

D. Inventories

Inventories of supplies are reported at cost and inventories held for resale are stated at the lower of average cost or market. In the government-wide financial statements, inventories for both governmental and business-type activities are expensed when consumed and unused inventories are reported as an asset on the Statement of Net Assets. In the fund financial statements, governmental funds report inventories as expenditures when purchased, and proprietary funds report inventories as expenditure when consumed. The discretely presented component units have inventory policies similar to those of the primary government.

E. Deposits and Investments

The State reports investments at fair value, as prescribed by GAAP. Additional information on the State's investments can be found in Note 3, Deposits and Investments.

F. Net Investment in Direct Financing Leases

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. The payments from these leases are used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board to finance the cost of projects such as acquisition and construction of facilities and equipment. Upon expiration of these leases, title to the facilities and projects transfers to the primary government agency, the University of California, or the local agency. The State Public Works Board records the net investment in direct financing leases at the net present value of the minimum lease payments.

G. Deferred Charges

The deferred charges account primarily represents operating and maintenance costs and unrecovered capital costs in the enterprise fund type that will be recognized as expenses over the remaining life of long-term state water supply contracts in the Water Resources Fund. These costs are billable in future years. In addition, the account includes unbilled interest earnings on unrecovered capital costs that are recorded as deferred charges. These charges are recognized when billed in future years under the terms of water supply contracts. The deferred charges for the Public Buildings Construction Fund include bond counsel fees, trustee fees, rating agency fees, underwriting costs, insurance costs, and miscellaneous expenses. Bond issuance costs are amortized using the straight-line method over the term of the bonds. Amortization of bond issue costs during the facility construction period is capitalized and included in the construction costs. Deferred charges are also included in the State Lottery Fund and nonmajor enterprise funds. Bond discounts and issuance costs recorded as expenditures in certain capital projects and special revenue funds are reclassified as deferred charges in the governmental activities column of the Statement of Net Assets.

H. Capital Assets

Capital assets are categorized into land, state highway infrastructure, collections, buildings and other depreciable property, and construction in progress. The buildings and other depreciable property account includes buildings, improvements other than buildings, equipment, personal property, intangible assets, certain infrastructure assets, certain books, and other capitalized and depreciable property. The value of the capital assets, including the related accumulated depreciation, is reported in the applicable governmental, business-type, or component unit activities columns in the government-wide Statement of Net Assets.

The primary government has a large collection of historical and contemporary treasures that have important documentary and artistic value. These assets are not capitalized or depreciated, because they are cultural resources and cannot reasonably be valued and/or the assets have inexhaustible useful lives. These treasures and works of art consist of furnishings, portraits and other paintings, books, statues, photographs, and miscellaneous artifacts. These collections meet the conditions for exemption from capitalization because the collections are: held for public exhibition, education, or research in furtherance of public service, rather than financial gain; protected, kept unencumbered, cared for, and preserved; and are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

In general, capital assets of the primary government are defined as assets that have a normal useful life of at least one year and a unit acquisition cost of at least $5,000. These assets are recorded at historical cost or estimated historical cost, including all costs related to the acquisition. Donated capital assets are recorded at

the fair market value on the date the gift was received. Major capital asset outlays are capitalized as projects are constructed.

Buildings and other depreciable property are depreciated using the straight-line method with no salvage value for governmental activities. Generally, buildings and other improvements are depreciated over 40 years, and equipment is depreciated over five years. Depreciable assets of business-type activities are depreciated using the straight-line method over their estimated useful or service lives, ranging from three to 100 years.

California has elected to use the modified approach for capitalizing the infrastructure assets of the state highway system. The state highway system consists of approximately 49,600 lane-miles and 12,100 bridges that are maintained by the California Department of Transportation. By using the modified approach, the infrastructure assets of the state highway system are not depreciated and all expenditures made for those assets, except for additions and improvements, are expensed in the period incurred. All additions and improvements made after June 30, 2001, are capitalized. All infrastructure assets that are related to projects completed prior to July 1, 2001, are recorded at the historical costs contained in annual reports of the American Association of State Highway and Transportation Officials (AASHTO) and the Federal Highway Administration.

The capital assets of the discretely presented component units are reported at cost at the date of acquisition, or at fair market value at the date of donation in the case of gifts. They are depreciated over their estimated useful service lives.

I. Long-term Obligations

Long-term obligations consist of certain unmatured general obligation bonds, certain unmatured revenue bonds, capital lease obligations, certificates of participation, commercial paper, the net pension obligation of the pension and other employee benefit trust funds, the liability for employees' compensated absences and workers' compensation claims, amounts owed for lawsuits, reimbursement for costs mandated by the State, the outstanding Proposition 98 funding guarantee owed to schools, the liability for Lottery prizes and annuities, and the primary government's share of the University of California pension liability that is due in more than one year. In the government-wide financial statements, current and noncurrent obligations are reported as liabilities in the applicable governmental activities, business-type activities, and component units columns of the Statement of Net Assets.

Bond premiums and discounts, as well as issuance costs, for business-type activities and component units are generally deferred and amortized over the life of the bonds. In these instances, bonds payable are reported net of the applicable premium or discount, and bond issuance costs are reported as deferred charges. Bond premiums and discounts, as well as issuance costs, for governmental activities are expensed in the year incurred in the fund financial statements. These costs are reported as deferred charges in the government-wide financial statements.

With approval in advance from the Legislature, certain authorities and state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds, building authorities, and agencies. The General Fund has no legal liability for payment of principal and interest on revenue bonds. With the exception of certain special revenue funds (Transportation Construction,

California State University Programs, and the Golden State Tobacco Securitization Corporation) and the building authorities' capital projects funds, the liability for revenue bonds is recorded in the respective fund.

J. Compensated Absences

The government-wide financial statements report both the current and the noncurrent liabilities for compensated absences, which are vested unpaid vacation and annual leave. However, unused sick-leave balances are not included in the compensated absences because they do not vest to employees. In the fund financial statements for governmental funds, only a relatively small liability is accrued because it is anticipated that compensated absences will not generally be used in excess of a normal year's accumulation. The amounts of vested unpaid vacation and annual leave accumulated by state employees are accrued in proprietary funds when incurred. In the discretely presented component units, the compensated absences are accounted for as in the proprietary funds of the primary government.

K. Net Assets and Fund Balance

The difference between fund assets and liabilities is called "net assets" on the government-wide financial statements, the proprietary and fiduciary fund statements, and the component unit statements; it is called "fund balance" on the governmental fund statements. The government-wide financial statements have the following categories of net assets.

Investment in capital assets, net of related debt, represents capital assets, net of accumulated depreciation, reduced by the outstanding principal balances of debt attributable to the acquisition, construction, or improvement of those assets.

Restricted net assets result from transactions with purpose restrictions and are designated as either *nonexpendable* or *expendable*. *Nonexpendable restricted net assets* are subject to externally imposed restrictions that must be retained in perpetuity. *Expendable restricted net assets* are subject to externally imposed restrictions that can be fulfilled by actions of the State.

Unrestricted net assets are neither restricted nor invested in capital assets, net of related debt.

In the fund financial statements, proprietary funds have categories of net assets similar to those in the government-wide statements. Governmental funds have two fund balance sections: *reserved and unreserved*. Part or all of the total fund balance may be reserved as a result of law or generally accepted accounting principles. Reserves represent those portions of the fund balances that are segregated for specific uses. The reserves of the fund balance for governmental funds are as follows.

Reserved for encumbrances represents goods and services that are ordered, but not received, by the end of the fiscal year.

Reserved for interfund receivables represents the noncurrent portion of advances to other funds that do not represent expendable available financial resources.

Reserved for loans receivable represents the noncurrent portion of loans receivable that does not represent expendable available financial resources.

*Reserved for continuing appropriation*s represents the unencumbered balance of all appropriations for which the period of availability extends beyond the period covered in the report. These appropriations are legally segregated for a specific future use.

The *unreserved* amounts represent the net of total fund balance, less reserves.

Fiduciary fund net assets are "amounts held in trust for benefits and other purposes."

L. Restatement of Beginning Fund Balances and Net Assets

1. Fund Financial Statements

The beginning fund balance of the **nonmajor governmental funds** was increased by a total of $97 million as a result of prior-period adjustments to correct errors, including the omission of $85 million in loans receivable.

Beginning net assets of the **discretely presented component units – enterprise activity** were increased by a total of $140 million. Of the total increase, $91 million was the result of reporting University of California Hastings School of the Law as an additional nonmajor discretely presented component unit. The remaining increase is composed of $35 million, primarily due to a change in accounting principle for the University of California, and a net $14 million prior period adjustment to correct errors for two other nonmajor component units.

2. Government-wide Financial Statements

The beginning net assets of the **governmental activities** and the **component units** were restated as described in the previous section for nonmajor governmental funds and discretely presented component units – enterprise activity, respectively.

M. Guaranty Deposits

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to ensure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

NOTE 2: BUDGETARY AND LEGAL COMPLIANCE

A. Budgeting and Budgetary Control

The State's annual budget is prepared primarily on a modified accrual basis for governmental funds. The Governor recommends a budget for approval by the Legislature each year. This recommended budget includes estimated revenues; however, revenues are not included in the annual budget bill adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated 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 and establish the legal level of control at the appropriation level for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders of the Governor.

Amendments to the original budget for the year ended June 30, 2005, were legally made, and they had the effect of decreasing spending authority for the year.

Appropriations are generally available for expenditure or encumbrance either in the year appropriated or for a period of three years if the legislation does not specify a period of availability. At the end of the availability period, the encumbering authority for the unencumbered balance lapses. Some appropriations continue indefinitely, while others are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period when the appropriation is available. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

B. Legal Compliance

State agencies are responsible for exercising basic budgetary control and ensuring that appropriations are not overspent. The State Controller's Office is responsible for overall appropriation control and does not allow expenditures in excess of authorized appropriations.

Financial activities are mainly controlled at the appropriation level but can vary, depending on the presentation and wording contained in the Budget Act. Certain items that are established at the category, program, component, or element level can be adjusted by the Department of Finance. For example, an appropriation for support may have detail accounts for personal services, operating expenses and equipment, and reimbursements. The Department of Finance can authorize adjustments between the detail accounts but cannot increase the amount of the overall support appropriation. While the financial activities are controlled at various levels, the legal level of budgetary control, or the extent to which management may amend the budget without seeking approval of the governing body, has been established in the Budget Act at the appropriation level for the annual operating budget.

NOTE 3: DEPOSITS AND INVESTMENTS

The State reports its investments at fair value. State statutes authorize investments in certain types of securities. The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). A single portfolio of investments exists, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below. In addition, certain funds have the authority to separately invest their cash.

The State of California has implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures,* for the year ended June 30, 2005. This statement required the disclosure of the following risks to the extent that they exist at the date of the statement of net assets:

Interest Rate Risk
Interest rate risk is the risk that the value of fixed income securities will decline because of changing interest rates. The prices of fixed income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

Credit Risk
Credit risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

Custodial Credit Risk
Custodial credit risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of its deposits, investments, or collateral.

Concentration of Credit Risk
Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

Foreign Currency Risk
Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

A. Primary Government

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to have investments in United States government securities, Federal agency securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, other debt securities, repurchase agreements, reverse repurchase agreements, and other investments.

The State Treasurer's Office administers a pooled investment program for the primary government and for certain discretely presented component units. As of June 30, 2005, the discretely presented component units accounted for approximately 3.6% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. For certain banks, the State Treasurer's Office maintains cash deposits that cover uncleared checks deposited in the State's accounts and that earn income which compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2005, totaling approximately $7.6 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires that collateral pledged for demand and time deposits be deposited with the State Treasurer.

As of June 30, 2005, the State Treasurer's Office had amounts on deposit with a fiscal agent totaling $30 million related to principal and interest payments to bondholders. Additionally, $11 million was in a compensating balance account with a custodial agent that was designed to provide sufficient earnings to cover fees for custodial services. These deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of securities in the State Treasurer's pooled investment program generally is based on quoted market prices. As of June 30, 2005, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 133 days. Weighted average maturity is the average number of days, given a dollar-weighted value of individual investments, that the securities in the portfolio have remaining from evaluation date to stated maturity.

The Pooled Money Investment Board provides oversight of the State Treasurer's pooled investment program. The purpose of the board is to design an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board

designates the amounts of money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2005, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program, even though they have the authority to make their own investments. Others may be required by legislation to participate in the program. As a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, by law, the earnings are to be assigned to the State's General Fund. Some of the $233 million in interest revenue received by the General Fund from the pooled investment program in the 2004-05 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This amortized cost method differs from the fair value method used to value investments in these financial statements; the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements.

The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

As of June 30, 2005, structured notes and asset-backed securities comprised slightly more than 2.4% of the pooled investments. A significant portion of the asset-backed securities consists of small-business loans and mortgage-backed securities. The small-business loans held in the portfolio are guaranteed by the Small Business Administration, an agency of the federal government. The mortgage-backed securities, which are called real estate mortgage investment conduits (REMICs), are securities backed by pools of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule. A portion of the asset-backed securities consisted of floating-rate notes. For floating-rate notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio hedged the portfolio against the risk of increasing interest rates.

Enterprise funds and special revenue funds also make separate investments, which are presented at fair value.

Table 1 identifies the investment types that are authorized by the California Government Code and the State Treasurer's Office investment policy for the pooled investment program.

Table 1

Authorized Investments

Authorized Investment Type	Maximum Maturity	Maximum Percentage of Portfolio	Maximum Investment in One Issuer	Credit Rating
U.S. Treasury Securities	5 years*	N/A**	N/A**	N/A**
Federal Agency Securities	5 years*	N/A**	N/A**	N/A**
Certificates of Deposit	5 years*	N/A**	N/A**	N/A**
Bankers Acceptances	180 days*	N/A**	N/A**	N/A**
Commercial Paper	180 days	30%	10% of issuer's outstanding Commercial Paper	A-2/P-2/F-2***
Corporate Bonds/Notes	5 years*	N/A**	N/A**	A/A/A****
Repurchase Agreements	1 year*	N/A**	N/A**	N/A**
Reverse Repurchase Agreements	1 year*	10%*	N/A**	N/A**

* Limitations are pursuant to the State Treasurer's Office Investment Policy for the Pooled Money Investment Account. The Government Code does not establish limits for investments of surplus moneys in this investment type.

** N/A = Neither the Government Code nor the State Treasurer's Office Investment Policy for the Pooled Money Investment Account sets limits for the investment of surplus moneys in this investment type.

*** The State Treasurer's Office Investment Policy for the Pooled Money Investment account is more restrictive than the Government Code, which allows investments rated A-3/P-3/F-3.

**** The Government Code requires that a security be within the top three ratings of a nationally recognized rating service.

1. Interest Rate Risk

Table 2 presents the interest rate risk of the primary government's investments.

Table 2

Schedule of Investments – Primary Government – Interest Rate Risk
June 30, 2005
(amounts in thousands)

	Interest Rates*	Maturity	Fair Value at Year End	Weighted Average Maturity (in years)
Pooled investments				
U.S. Treasury bills and notes	1.50 – 3.45	46 days - 1.42 years	$ 5,680,299	0.58
U. S. Agency bonds and discount notes	1.36 – 3.95	5 days - 2.2 years	13,321,547	0.61
Small Business Administration loans	3.05 – 3.88	.25 year	718,199	0.25 **
Mortgage-backed securities #	3.92 – 14.25	1 day - 5 years	531,822	1.98
Certificates of deposit	2.80 – 3.51	1 day - .42 year	14,434,037	0.16
Commercial paper	2.87 – 3.42	1 day - .42 year	10,591,838	0.10
Corporate bonds and notes	1.44 – 6.48	1 day - 1.96 years	2,894,788	0.48 ***
Total pooled investments			**48,172,530**	
Other primary government investments				
U.S. Treasuries and agencies			2,736,231	6.05
Commercial paper			458,459	N/A ****
Guaranteed investment contracts			722,773	16.10
Corporate debt securities			155,718	2.09
Other			228,859	2.12
Total other primary government investments			**4,302,040**	
Funds outside primary government included in pooled investments				
Less: investment trust funds			18,662,977	
Less: other trust and agency funds			2,380,312	
Less: discretely presented component units			2,193,105	
Total primary government investments			**$ 29,238,176**	

* These numbers represent high and low interest rates for each investment type.

** In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes stated maturity is the quarterly reset date.

*** For corporate bond floating rate securities, the State Treasurer's Office assumes final maturity date in calculating weighted average maturity.

**** These commercial paper holdings of the Golden State Tobacco Securitization Corporation mature in less than 1 year.

These securities are issued by U. S. government agencies such as the Federal National Mortgage Association.

Table 3 identifies the debt securities that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously).

Table 3

Schedule of Highly Sensitive Investments in Debt Securities – Primary Government – Interest Rate Risk
June 30, 2005
(amounts in thousands)

Pooled investments	Fair Value at Year End	% of Total Pooled Investments
Mortgage-backed		
Federal National Mortgage Association Collateralized Mortgage Obligations	$ 529,282	1.099 %
Government National Mortgage Association Pools	356	0.001
Federal Home Loan Mortgagee Corporation Participation Certificate Pools	2,184	0.005

These federal agency securities are mortgage-backed securities which entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage securities are sensitive to interest rate changes because principal payments either increase (in a low interest rate environment) or decrease (in a high interest rate environment). A change, up or down, in the payment rate will result in a change in the security yield.

2. Credit Risk

Table 4 presents the credit risk of the primary government's debt securities.

Table 4

Schedule of Investments in Debt Securities – Primary Government – Credit Risk
June 30, 2005
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
Pooled investments*		
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 33,209,023 **
A-1/P-1/F-1	AA/Aa/AA	7,001,755
A-2/P-2/F-2	A/A/A	884,641
	BB***	146,792
Not rated		531,466
Not applicable		6,398,853
Total pooled investments		**$ 48,172,530**
Other primary government investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 1,106,401
A-1/P-1/F-1	AA/Aa/AA	273,282
A-2/P-2/F-2	A/A/A	133,512
Not rated		305,161
Not applicable		2,483,684
Total other primary government investments		**$ 4,302,040**

* The Treasurer's Office utilizes Standard & Poor's, Moody's, and Fitch ratings services. Securities are classified by the lowest rating of the three agencies.

** This amount includes $7.0 billion in Freddie Mac issued discount notes. Freddie Mac has not requested that all of its debt be rated, but all debt which has been rated received S&P's and Moody's top ratings.

*** This holding represents multiple maturities of one issuer, General Motors Acceptance Corporation. These securities were within the top three ratings of a nationally recognized rating service when purchased.

3. Concentration of Credit Risk

The investment policy of the State Treasurer's Office contains no limitations on the amount that can be invested in any one issuer beyond those limitations stipulated in the California Government Code. Table 5 identifies debt securities in any one issuer (other than U.S. Treasury securities) that represent 5% or more of the State Treasurer's investments, or of the separate investments of other primary government funds.

Table 5

Schedule of Investments – Primary Government – Concentration of Credit Risk
June 30, 2005
(amounts in thousands)

POOLED INVESTMENTS

Issuer	Investment Type	Reported Amount	% of Total Pooled Investments
Federal Home Loan Mortgage Corp.	U.S. agency securities	$ 7,020,915	14.57 %
Federal Home Loan Bank	U.S. agency securities	5,684,851	11.80
General Electric Capital/GE Company	Corporate Bonds/Commercial Paper	3,502,883	7.27

OTHER PRIMARY GOVERNMENT INVESTMENTS

Issuer	Investment Type	Reported Amount	% of Total Agency Investments
Golden State Tobacco Securitization Corporation			
American General Finance	Commercial paper	$ 63,450	13.84 %
Briarwood	Commercial paper	63,543	13.86
Morgan Stanley	Commercial paper	134,925	29.43
Security Benefit Life Insurance	Commercial paper	65,010	14.18
Golden Fish LLC	Commercial paper	71,061	15.50
Landesbank Baden Wurttemburg	Commercial paper	60,470	13.19
California State University			
Federal Home Loan Bank	U.S. agency securities	$ 91,905	6.30 %
Department of Veterans Affairs			
Bayerische Landesbank	Guaranteed investment contracts	$ 62,193	41.87 %
Societe Generale	Guaranteed investment contracts	16,440	11.07
Westdeutsche Landesbank	Guaranteed investment contracts	62,182	41.86

4. Custodial Credit Risk

The State of California has a deposit policy for custodial credit risk that requires that deposits held by financial institutions be insured by federal depository insurance or secured by collateral. As of June 30, 2005, $10 million in deposits of the Electric Power Fund and $10 million in deposits of the Water Resources Development System were held in uninsured and uncollateralized accounts with U.S. Bank.

B. Fiduciary Funds

The fiduciary funds include pension and other employee benefit trust funds of the following fiduciary funds and component units: the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), the University of California Retirement System (UCRS), the fund for the California Scholarshare program, and various other funds. CalPERS, CalSTRS, and UCRS account for 98% of these separately invested funds.

CalPERS and CalSTRS exercise their authority under the State Constitution and invest in stocks, bonds, mortgages, real estate, and other investments.

CalPERS reports investments in securities at fair value, generally based on published market prices and quotations from major investment firms. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock, less an appropriate discount.

CalPERS' mortgages are valued on the basis of their future principal and interest payments, discounted at prevailing interest rates for similar instruments. The fair value of real estate investments, principally rental property subject to long-term net leases, is estimated based on independent appraisals. Short-term investments are reported at market value, when available, or, when market value is not available, at cost plus accrued interest, which approximates market value. For investments where no readily ascertainable market value exists, management, in consultation with its investment advisors, determines the fair values for the individual investments.

Under the State Constitution and statutory provisions governing CalPERS' investment authority, CalPERS, through its outside investment managers, holds investments in futures and options and enters into forward foreign currency exchange contracts. CalPERS held for investment purposes futures and options with a fair value of approximately $393 million as of June 30, 2005. Gains and losses on futures and options are determined based upon quoted market values and recorded in the statement of changes in fiduciary net assets.

Due to the level of risk associated with certain derivative investment securities, it is reasonably possible that investment securities values will change in the near term; such changes could materially affect the amounts reported in the financial statements.

CalPERS uses forward foreign currency exchange contracts primarily to hedge against changes in exchange rates related to foreign securities. As of June 30, 2005, CalPERS had an approximately $393 million net exposure to loss from forward foreign currency exchange transactions related to the approximately $43.0 billion international debt and equity portfolios. CalPERS could be exposed to risk if the counterparties to the contracts are unable to meet the terms of the contracts. CalPERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures. CalPERS anticipates that the counterparties will be able to satisfy their obligations under the contracts.

CalSTRS also reports investments at fair value, generally based on published market prices and quotations from major investment firms for securities. In the case of debt securities acquired through private placements, management computes fair value based on market yields and average maturity dates of comparable quoted securities. Mortgages are valued based on future principal and interest payments, and are discounted at

prevailing interest rates for similar instruments. Real estate equity investment fair values are based on either recent estimates provided by CalSTRS' contract real estate advisors or by independent appraisers. Short-term investments are reported at cost or amortized cost, which approximates fair value. Alternative investments represent interests in private equity partnerships which the system enters into under a limited partnership agreement. For alternative investments and other investments where no readily ascertainable market value exists, CalSTRS management, in consultation with its investment advisors, has determined the fair value for the individual investments. Purchases and sales are recorded on the trade date.

The State Constitution, state statutes, and board policies permit CalPERS and CalSTRS to lend their securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. Third-party securities lending agents are under contract to lend domestic and international equity and debt securities. For both CalPERS and CalSTRS, collateral, in the form of cash or other securities, is required at 102% and 105% of the fair value of domestic and international securities loaned, respectively. CalPERS' management believes CalPERS has minimized its credit risk exposure by requiring the borrowers to provide collateralization greater than 100% of the market value of the securities loaned. The securities lent are priced daily. Securities on loan can be recalled on demand by CalPERS and loans of securities may be terminated by CalPERS or the borrower.

For CalPERS, the weighted average maturities of the collateral invested by three externally managed portfolios and one internally managed portfolio were 349 days, 114 days, 113 days, and 285 days. In accordance with CalPERS' investment guidelines, the cash collateral was invested in short-term investment funds that, at June 30, 2005, had durations of 44 days, 29 days, 39 days, and 23.74 days, for three externally managed portfolios and one internally managed portfolio. For one externally managed portfolio, the duration of the collateral is matched with the duration of the loan.

For CalSTRS, collateral received on each security loan was placed in investments that, at June 30, 2005, had a 10-day difference in weighted average maturity between the investments and loans. Most of CalSTRS' security loans can be terminated on demand by CalSTRS or the borrower. As of June 30, 2005, CalSTRS has no credit risk exposure to borrowers because the amounts it owes the borrowers exceed the amounts the borrowers owe it. CalSTRS is not permitted to pledge or sell collateral securities received unless the borrower defaults. The contracts with the security lending agents require them to indemnify CalSTRS if the borrowers fail to return the securities (or if the collateral is not sufficient to replace the securities lent) or if the borrowers fail to pay CalSTRS for income distributions by the securities' issuers while the securities are on loan.

The Regents of the University of California (regents), as the governing board, are responsible for the management of the university's and the UCRS's investments and for establishing investment policy. For more information about the investment policies of the University of California, refer to section C, Discretely Presented Component Units.

Table 6 presents the investments of the fiduciary funds by investment type.

Table 6

Schedule of Investments - Fiduciary Funds
June 30, 2005
(amounts in thousands)

Investment Type	Fair Value
Equity securities	$ 227,060,642
Debt securities*	111,612,115
Investment contracts	2,514,332
Mutual funds	5,044,601
Real estate	18,204,480
Money market securities	534,683
Insurance contracts	928,098
Private equity	17,446,410
Securities lending collateral	69,652,234
Total investments	**$ 452,997,595**

* Debt securities include short-term investments not included in Cash and Pooled Investments.

1. Interest Rate Risk

CalPERS, CalSTRS, and UCRS manage the interest rate risk inherent in their investment portfolios by measuring the effective or option-adjusted duration of the portfolio. In using the duration method, these agencies may make assumptions regarding the timing of cash flows or other factors that affect interest rate risk information. The CalPERS investment policies require the option-adjusted duration of the total fixed income portfolio to stay within 20% of the option adjusted duration of its benchmark (Lehman Brothers Long Liabilities). All individual portfolios are required to maintain a specific level of risk relative to their benchmark. Risk exposures are monitored daily. The CalSTRS investment guidelines allow the internally managed long-term investment grade portfolios the discretion to deviate within plus or minus .50 years from the effective duration of the relevant Lehman Brothers benchmark. The permissible range of deviation for the effective duration within the high yield portfolios is negotiated with each of the high yield managers and detailed within the investment guidelines. The CalSTRS investment guidelines state that 50% of the portfolio shall reflect an expected maturity, first call date or first reset date to be within a 0-30 day range and/or in U.S. government and agency obligations. The UCRS portfolio guidelines for the fixed income portion of the UCRS investments limit weighted average effective duration to the effective duration of the benchmark (Citigroup Large Pension Fund), plus or minus 20%.

Table 7 presents the interest rate risk of the fixed income securities of these fiduciary funds.

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Table 7

Schedule of Investments in Fixed Income Securities - Fiduciary Funds - Interest Rate Risk
June 30, 2005
(amounts in thousands)

	Fair Value at Year End	Effective Duration*
California Public Employees' Retirement Fund		
U.S. Treasuries and agencies	$ 13,106,542	8.32
Mortgages	18,125,088	3.66
Corporate	11,361,713	8.76
Asset-backed	7,230,777	2.54
International	4,516,658	9.66
Total	**$ 54,340,778**	
University of California Retirement System		
U.S. Treasury bills, notes, and bonds	$ 2,598,387	2.10
U.S. Treasury strips	1,919,297	14.00
U.S. Treasury Inflation-Protected Securities	2,581,848	4.40
U.S. government-backed securities	16,696	6.90
U.S. government-backed asset-backed securities	78,870	2.70
Corporate bonds	2,809,783	9.10
Commercial paper	788,560	0.00
U.S. agencies	3,210,451	3.20
U.S. agencies asset-backed securities	2,994,743	2.30
Corporate asset-backed securities	553,811	1.70
Supranational/foreign	737,758	8.30
Other	6,918	14.80
Corporate (foreign currency denominated)	74,037	13.10
Money market funds	534,683	2.10
Total	**$ 18,905,842**	
California State Teachers' Retirement System		
Long-term fixed income investments		
U.S. Government and agency obligations	$ 8,066,427	4.97
Corporate	8,078,651	5.83
High yield	2,748,841	3.95
Asset-backed securities	825,092	2.64
Commercial mortgage-backed securities	860,813	4.39
Mortgage-backed securities	11,062,286	2.22
Total	**$ 31,642,110**	

	0-30 days	31-90 days	91-120 days
Short-term fixed income investments			
Money market securities	$ 872,765	$ 112,838	$ —
Corporate bonds	—	—	—
Corporate floating-rate notes	466,713	418,220	27,997
U.S. Government and agency obligations			
Noncallables	—	—	—
Discount notes	—	99,737	—
Callable	8,000	318,987	148,997
U.S. Treasury	—	—	—
Asset-backed securities	59,850	73,670	2,850
Total	**$ 1,407,328**	**$ 1,023,452**	**$ 179,844**

* Effective duration is described in the paragraph preceding this table.

121-180 days	181-365 days	365+ days	Fair Value at Year End
$ —	$ —	$ —	$ 985,603
—	4,999	24,972	29,971
—	—	—	912,930
—	50,056	54,707	104,763
—	—	—	99,737
26,500	—	—	502,484
—	75,241	—	75,241
—	19,999	—	156,369
$ 26,500	**$ 150,295**	**$ 79,679**	**$ 2,867,098**

Table 8 identifies the debt securities of the University of California Retirement System that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously) because of the existence of prepayment or converstion features, although the effective duration of these secrurites may be low.

Table 8

Schedule of Highly Sensitive Investments in Debt Securities – University of California Retirement System – Interest Rate Risk
June 30, 2005
(amounts in thousands)

	Fair Value at Year End	Effective Duration
Mortgage Pass-Through Securities These securities are issued by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae), and Federal Home Loan Mortgage Association (Freddie Mac) and include short embedded prepayment options. Unanticipated prepayments by the obligees of the underlying asset reduce the total expected rate of return.	$ 3,522,099	1.80
Collateralized Mortgage Obligations Collateralized mortgage obligations (CMOs) generate a return based upon either the payment of interest or principal on mortgages in an underlying pool. The relationship between interest rates and prepayments makes the fair value highly sensitive to changes in interest rates. In falling interest rate environments, the underlying mortgages are subject to a higher propensity of prepayments. In a rising interest rate environment, the opposite is true.	105,325	3.50
Callable Bonds Although bonds are issued with clearly defined maturities, an issuer may be able to redeem, or call, a bond earlier than its maturity date. The university must then replace the called bond with a bond that may have a lower yield than the original. The call feature causes the fair value to be highly sensitive to changes in interest rates.	880,196	4.00

2. Credit Risk

The CalPERS investment policies require that 90% of the total fixed income portfolio be invested in investment grade securities. Investment grade securities are those fixed income securities with a Moody's rating of AAA to BAA or a Standard and Poors rating of AAA to BBB. Each portfolio is required to maintain a specified risk level. Portfolio exposures are monitored daily. The CalSTRS investment guidelines require that the lowest long-term credit rating of securities eligible for purchase by the internally managed fixed income assets be Baa3 by Moody's Investor Services or BBB- by Standard and Poor's Corporation (i.e., investment grade by at least one major rating agency). Furthermore, the total position of the outstanding debt of any one issuer shall be limited to 10% of the market value of the portfolio. The investment guidelines also include an allocation to high yield assets which are managed externally and allow for the purchase of bonds rated below investment grade. Limitations regarding the amount of debt of any one issuer a manager may hold is negotiated on a manager-by-manager basis. The UCRS uses a benchmark chosen for the fixed income portion of its portfolio to manage credit risk. That fixed income benchmark, the Citigroup Large Pension Fund Index (LPF), is comprised of approximately 30% high grade corporate bonds and 30% mortgage/asset-backed securities. The remaining 40% are government-issued bonds. Credit risk in the UCRS is managed primarily by diversifying across issuers, and portfolio guidelines mandate that no more than 10% of the

market value of fixed income securities may be invested in issues with credit ratings below investment grade. Further, the weighted average credit rating must be A or higher.

Table 9 presents the credit risk of the fixed income securities of these fiduciary funds.

Table 9

Schedule of Investments in Fixed Income Securities – Fiduciary Funds – Credit Risk
June 30, 2005
(amounts in thousands)

Credit Rating as of Year End			
Short-term	**Long-term**		**Fair Value**
A-1+/P-1/F-1+	AAA/Aaa/AAA	$	54,761,028
A-1/P-1/F-1	AA/Aa/AA		9,026,450
A-2/P-2/F-2	A/A/A		15,451,049
A-3/P-3/F-3	BBB/Baa/BBB		10,953,632
B/NP/C	BB/Ba/BB		2,123,437
B/NP/C	B/B/B		2,413,621
C/NP/C	CCC/Caa/CCC		613,490
C/NP/C	CC/Ca/CC		82,154
C/NP/C	C/C/C		301
Not rated			20,905,415
Total fixed income securities		**$**	**116,330,577**

3. Concentration of Credit Risk

UCRS held $3.5 billion in Federal agency securities of the Federal National Mortgage Association, which represented 6.91% of UCRS's total investments as of June 30, 2005. CalPERS and CalSTRS did not have investments in a single issuer that represented 5% or more of total fair value of all investments.

4. Custodial Credit Risk

CalPERS, CalSTRS, and UCRS have policies or practices to minimize custodial risk, and their investments at June 30, 2005, were not exposed to custodial risk.

5. Foreign Currency Risk

At June 30, 2005, CalPERS, CalSTRS, and UCRS held $45.3 billion, $23.5 billion, and $4.2 billion, respectively, in investments subject to foreign currency risk. CalPERS' asset allocation and investment policies allow for active and passive investments in international securities. CalPERS' target allocation is to have 20% of total global equity assets invested in international equities and 11.5% of total fixed income invested in international securities. Real estate and alternative investments do not have a target allocation for international investment. CalPERS uses a currency overlay program to reduce risk by hedging up to 30% of the total international equity portfolio. Its currency exposures are monitored daily. CalSTRS believes that its currency management program should emphasize the protection of the value of its non-dollar public and private (i.e. international debt and equity, alternative investments and real estate) equity assets against a strengthening U.S. dollar. The active non-dollar equity managers are permitted to hedge their assets, and do

so in the process of implementing their investment strategies. CalSTRS' fixed income staff develops and implements its currency hedging strategy for the passively managed equity portion. Its fixed income staff may reduce the risk by hedging up to 50% of the total market value of the passively managed segment of the non-dollar equity portfolio. In addition, no more than 100% of each individual currency may be hedged. UCRS' portfolio guidelines for fixed income securities allow exposure to non-US dollar denominated bonds up to 10% of the total portfolio market value. Exposure to foreign currency risk from these securities is permitted and it may be fully or partially hedged using forward foreign currency exchange contracts. Under the university's investment policies, such instruments are not permitted for speculative use or to create leverage.

Table 10 identifies the investments of these fiduciary funds that are subject to foreign currency risk.

Table 10

Schedule of Investments - Fiduciary Funds - Foreign Currency Risk
June 30, 2005
(amounts in thousands of U.S. dollars at fair value)

Currency	Cash	Equity	Alternative	Fixed Income	Real Estate	Currency Overlay	Total
Argentine Peso	$ 5	$ 13	$ —	$ —	$ —	$ —	$ 18
Australian Dollar	63,255	2,858,931	3,755	248,237	—	(247)	3,173,931
Brazilian Real	6,606	787,973	—	—	—	—	794,579
British Pound Sterling	365,139	13,943,216	63,506	318,189	—	20,487	14,710,537
Canadian Dollar	12,188	2,189,125	8,861	99,826	9,314	2,524	2,321,838
Chilean Peso	708	61,362	—	—	—	—	62,070
Chinese Yuan	(2)	4,345	—	—	—	—	4,343
Czech Koruna	169	42,944	—	—	—	—	43,113
Danish Krone	12,692	568,336	757	131,352	—	(2,541)	710,596
Euro	396,275	22,261,230	340,905	2,310,824	—	(2,149,551)	23,159,683
Hong Kong Dollar	40,500	1,568,123	—	—	—	2,128	1,610,751
Hungarian Forint	496	164,066	—	10,197	—	—	174,759
Indian Rupee	7,197	231,540	—	—	—	—	238,737
Indonesian Rupiah	535	125,751	—	—	—	—	126,286
Israeli Shekel	1,332	254,766	—	—	—	—	256,098
Japanese Yen	252,500	11,582,184	14,717	1,122,273	—	55,137	13,026,811
Malaysian Ringgit	2,081	243,602	—	—	—	—	245,683
Mexican Peso	4,487	601,668	—	33,770	—	—	639,925
New Zealand Dollar	3,832	264,203	—	—	—	(12)	268,023
Norwegian Krone	6,581	575,975	—	88,179	—	1,298	672,033
Philippine Peso	4	146,277	—	—	—	—	146,281
Polish Zloty	378	84,804	—	76,474	—	—	161,656
Singapore Dollar	2,833	1,065,756	—	34,999	—	63	1,103,651
South African Rand	10,748	790,193	—	—	—	(1,918)	799,023
South Korean Won	825	1,361,022	—	30,676	—	—	1,392,523
Swedish Krona	43,354	1,449,990	—	50,567	—	2,881	1,546,792
Swiss Franc	126,718	3,912,353	371	—	—	(498,846)	3,540,596
Taiwan Dollar	7,969	863,587	—	—	—	—	871,556
Thailand Baht	5,898	184,463	—	—	—	—	190,361
Turkish New Lira	1,912	339,799	—	—	—	—	341,711
Other	—	6,488	—	—	—	—	6,488
Various denominations	—	636,495	—	—	—	—	636,495
Total exposure to foreign currency risk	**$ 1,377,215**	**$ 69,170,580**	**$ 432,872**	**$ 4,555,563**	**$ 9,314**	**$ (2,568,597)**	**$ 72,976,947**

C. Discretely Presented Component Units

The discretely presented component units consist of the University of California and its foundations, the State Compensation Insurance Fund (SCIF), the California Housing Finance Authority (CalHFA), certain employee benefit funds administered by CalPERS, and various funds that constitute less than 3% of the total investments of discretely presented component units. State law, bond resolutions, and investment policy

resolutions allow component units to invest in U.S. government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, real estate, and other investments. Additionally, a portion of the cash and pooled investments of SCIF, CalHFA, and other component units is invested in the State Treasurer's pooled investment program.

The investments of the University of California, a discretely presented component unit, and of the UCRS, a pension and other employee benefit trust fund reported in the Fiduciary Fund statements of the primary government, are primarily stated at fair value. Investments authorized by the regents include equity securities, fixed-income securities, and certain other asset classes. The equity portion of the investment portfolio includes domestic and foreign common and preferred stocks, which may be included in actively managed and passive (index) strategies, along with a modest exposure to private equities. Private equities include venture capital partnerships, buy-outs, and international funds. The fixed-income portion of the investment portfolio may include both domestic and foreign securities, along with certain securitized investments including mortgage-backed and asset-backed securities. Absolute return strategies, incorporating short sales, plus derivative or option positions to implement or hedge an investment position, are also authorized. Where donor agreements place constraints on allowable investments, assets associated with endowments are invested in accordance with the terms of the agreements.

The University of California and UCRS jointly participate in a securities lending program as a means to augment income. Campus foundations' cash and cash equivalents and investments that are invested with the University of California and managed by the university's treasurer are included in the university's investment pools that participate in a securities lending program. The campus foundations' allocated share of the program's cash collateral received, investment of cash collateral and collateral held for securities lending is determined based upon their equity in the investment pools. The Board of Trustees for each campus foundation may also authorize participation in a direct securities lending program. The university loans securities to selected brokerage firms and receives collateral in excess of the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U.S. government or its agencies, or the sovereign or provincial debt of foreign countries. Collateral securities cannot be pledged or sold by the university unless the borrower defaults. Loans of domestic equities and all fixed-income securities are initially collateralized at 102% of the fair value of the securities loaned. Loans of foreign equities are initially collateralized at 105%. All borrowers are required to provide additional collateral by the next business day if the value falls to less than 100% of the fair value of the securities loaned. The university earns interest and dividends on the collateral held during the loan period, as well as a fee from the brokerage firm, and is obligated to pay a fee and a rebate to the borrower. The university receives the net investment income. As of June 30, 2005, the university had no exposure to borrowers, because the amounts the university owed the borrowers exceeded the amounts the borrowers owed the university. The university is fully indemnified by its custodial bank against any losses incurred as a result of borrower default.

Securities loans immediately terminate upon notice by either the university or the borrower. Cash collateral is invested by the university's lending agent in a short-term investment pool in the university's name, with guidelines approved by the university. As of June 30, 2005, the securities in this pool had a weighted average maturity of 30 days.

The State Department of Insurance permits SCIF to lend a certain portion of its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. A third-party lending agent has been contracted to lend U.S. Treasury notes and bonds. Collateral, in the form of cash and other securities, is adjusted daily and is required at all times to equal at least 100% of the fair value of securities loaned. Collateral securities received cannot be pledged or sold unless the borrower defaults. The maximum loan term is one year. In accordance with SCIF's investment guidelines, cash collateral was

invested in short-term investments at December 31, 2004, with maturities matching the related loans. Interest income on these investments is shared by the borrower, the third-party lending agent, and SCIF.

Table 11 presents the investments of the discretely presented component units by investment type.

Table 11

Schedule of Investments – Discretely Presented Component Units
June 30, 2005
(amounts in thousands)

Investment Type	Fair Value
Equity securities	$ 5,284,658
Debt securities*	26,905,780
Investment contracts	2,660,943
Mutual funds	2,550,171
Real estate	197,981
Money market securities	380,113
Private equity	230,855
Mortgage loans	103,567
Externally held irrevocable trusts	256,977
Securities lending collateral	3,794,111
Invested for others	(1,380,860)
Other	1,110,727
Total investments	**$ 42,095,023**

* Debt securities include short-term investments not included in Cash and Pooled Investments.

1. Interest Rate Risk

Interest rate risk for the University of California's short-term investment pool is managed by constraining the maturity of all individual securities to be less than five and one-half years. There is no restriction on weighted average maturity of the portfolio as it is managed relative to the liquidity demands of the investors. Portfolio guidelines for the fixed income portion of the university's general endowment pool limit weighted average effective duration to the effective duration of the benchmark (Citigroup Large Pension Fund), plus or minus 20%.

SCIF guidelines provide that not less than 15% of the total assets shall be maintained in cash or in securities maturing in five years or less. For information about CalPERS' policies related to interest rate risk, refer to section B, Fiduciary Funds.

Table 12 presents the interest rate risk of the fixed income securities of the major discretely presented component units.

Table 12

Schedule of Investments in Fixed Income Securities - Discretely Presented Component Units - Interest Rate Risk
June 30, 2005
(amounts in thousands)

Investment Type	University of California		University of California Foundations	
	Fair Value at Year End	Effective Duration	Fair Value at Year End	Effective Duration
U.S. Treasury bills, notes, and bonds	$ 1,648,305	2.80	$ 127,216	1.30
U.S. Treasury strips	193,062	14.00	—	—
U.S. TIPS	254,419	4.40	—	—
U.S. government-backed securities	4,288	6.90	6,042	3.60
U.S. government-backed asset-backed securities	8,248	2.60	25	0.60
Corporate bonds	1,932,914	2.90	60,524	5.40
Commercial paper	2,910,091	0.00	—	—
U.S. agencies	908,297	1.80	81,354	1.60
U.S. agencies asset-backed securities	247,855	2.30	2,971	0.90
Corporate asset-backed securities	52,820	1.50	3,240	1.60
Supranational/foreign	911,665	2.30	640	2.80
Other	707	8.10	856	2.80
Corporate (foreign currency denominated)	10,423	23.20	—	—
U.S. bond funds	44,799	4.20	228,860	4.10
Non-U.S. bond funds	—	—	14,429	5.00
Money market funds	7,304	0.00	343,260	2.10
Mortgage loans	99,021	0.00	4,546	0.00
Total	**$ 9,234,218**		**$ 873,963**	

Investment Type	State Compensation Insurance Fund		California Housing Finance Agency		Public Employees' Benefits Fund*	
	Fair Value at Year End	Weighted Average Maturity	Fair Value at Year End	Effective Duration	Fair Value at Year End	Effective Duration
Securities lending collateral	$ 928,024	0.04	$ —	—	$ —	—
U.S. Treasury and agency securities	4,788,616	3.47	52,779	9.55	224,433	6.79
Municipal securities	491,131	4.74	—	—	—	—
Public utilities	577,792	5.66	—	—	—	—
Corporate bonds	5,280,821	5.27	—	—	187,013	8.67
Commercial paper	—	—	7,456	0.27	—	—
Special revenue	651,708	9.85	—	—	—	—
Other government	49,450	3.92	—	—	41,332	6.75
Mortgage-backed securities	4,784,011	5.44	—	—	213,184	2.85
Mutual funds	250,983	0.08	—	—	—	—
Asset-backed	—	—	—	—	45,577	0.45
Sovereign	—	—	—	—	14,830	10.22
Pooled	—	—	—	—	68,645	—
Total	**$ 17,802,536**		**$ 60,235**		**$ 795,014**	

* Includes investments of discretely presented component units and certain fiduciary funds that CalPERS administers.

Table 13 identifies the debt securities that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously), because of the existence of prepayment or conversion features although the effective duration of these securities may be low.

Table 13

Schedule of Highly Sensitive Investments in Debt Securities – University of California and its Foundations – Interest Rate Risk
June 30, 2005
(amounts in thousands)

	University of California		University of California Foundations	
	Fair Value at Year End	Effective Duration	Fair Value at Year End	Effective Duration
Mortgage Pass-Through Securities These securities are issued by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) and include short embedded prepayment options. Unanticipated prepayments by the obligees of the underlying asset reduce the total expected rate of return.	$ 308,923	2.10	$ 56,231	1.50
Collateralized Mortgage Obligations Collateralized mortgage obligations (CMOs) generate a return based upon either the payment of interest or principal on mortgages in an underlying pool. The relationship between interest rates and prepayments makes the fair value highly sensitive to changes in interest rates. In falling interest rate environments, the underlying mortgages are subject to a higher propensity of prepayments. In a rising interest rate environment, the underlying mortgages are subject to a lower propensity of prepayments.			19,944	1.50
Other Asset-Backed Securities Other asset-backed securities also generate a return based upon either the payment of interest or principal on obligations in an underlying pool, generally associated with auto loans or credit cards. As with CMOs, the relationship between interest rates and prepayments makes the fair value highly sensitive to changes in interest rates.			2,965	1.70
Callable Bonds Although bonds are issued with clearly defined maturities, an issuer may be able to redeem, or call, a bond earlier than its maturity date. The university must then replace the called bond with a bond that may have a lower yield than the original. The call feature causes the fair value to be highly sensitive to changes in interest rates.	22,160	5.20	1,245	1.50

2. Credit Risk

The investment guidelines for the University of California's short-term investment pool provide that no more than 5% of the total market value of the pool's portfolio may be invested in securities rated below investment grade (BB, Ba or lower). The average credit quality of the pool must be A or better and commercial paper must be rated at least A-1 or P-1. For its general endowment pool, the university uses a fixed income benchmark, the Citigroup Large Pension Fund Index (LPF), which is comprised of approximately 30% high grade corporate bonds and 30% mortgage/asset-backed securities, all of which carry some degree of credit risk. The remaining 40% are government-issued bonds. Credit risk in this pool is managed primarily by diversifying across issuers, and portfolio guidelines mandate that no more than 10% of the market value of fixed income securities may be invested in issues with credit rating below investment grade. Further, the weighted average credit rating must be A or higher.

SCIF investment guidelines provide that securities issued and/or guaranteed by the government of Canada and its political subdivisions must be rated AA or equivalent by a nationally recognized rating service, provided the rating of another service, if it has a rating, is not less than AA. Securities issued and/or guaranteed by a state or its political subdivision must be rated A or equivalent by a nationally recognized rating service, provided the rating of another service, if it has a rating, is not less than A. Securities issued by a qualifying corporation must be rated A or equivalent by a nationally recognized rating service, provided the rating of another service, if it has a rating, is not less than A.

Table 14 presents the credit risk of the fixed income securities of the major discretely presented component units.

Table 14

Schedule of Investments in Fixed Income Securities – Discretely Presented Component Units – Credit Risk
June 30, 2005
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 13,483,957
A-1/P-1/F-1	AA/Aa/AA	7,085,632
A-2/P-2/F-2	A/A/A	6,028,335
A-3/P-3/F-3	BBB/Baa/BBB	548,674
B/NP/C	BB/Ba/BB	125,465
B/NP/C	B/B/B	488
Not rated		1,009,025
Total fixed income securities		**$ 28,281,576**

3. Concentration of Credit Risk

Investment guidelines addressing concentration of credit risk related to the fixed income portion of the University of California's portfolio include a limit of no more than 3% of the portfolio's market value to be invested in any single issuer (except for securities issued by the U.S. government or its agencies). These same guidelines apply to the university's short-term investment pool. Each campus foundation may have its own individual investment policy designed to limit exposure to a concentration of credit risk. The University of

California held $702 million in Federal agency securities of the Federal National Mortgage Association, which represented 5.82% of the university's total investments as of June 30, 2005.

4. Custodial Credit Risk

The University of California's securities are registered in the university's name by the custodial bank as an agent for the university. Other types of investments represent ownership interests that do not exist in physical or book-entry form. As a result, custodial credit risk is remote. Some of the investments at certain of the University of California campus foundations are exposed to custodial credit risk. These investments may be uninsured, or not registered in the name of the campus foundation and held by a custodian.

Table 15 presents the fixed income securities of the major discretely presented component units subject to custodial credit risk.

Table 15

Schedule of Investments in Fixed Income Securities – University of California Foundations – Custodial Credit Risk
June 30, 2005
(amounts in thousands)

	Fair Value
Investment Type	
Domestic equity securities	$ 193,151
Foreign equity securities	12,844
U.S. Treasury bills, notes, and bonds	46,302
U.S. government-backed securities	1,604
Corporate bonds	16,467
U.S. agencies	24,033
Corporate asset-backed securities	275

5. Foreign Currency Risk

The University of California's portfolio guidelines for fixed income securities allow exposure to non-U.S. dollar denominated bonds up to 10% of the total portfolio market value. Exposure to foreign currency risk from these securities may be fully or partially hedged using forward foreign currency exchange contracts. Under the university's investment policies, such instruments are not permitted for speculative use or to create leverage.

Table 16 identifies the investments of the University of California – including its campus foundations – that are subject to foreign currency risk.

Table 16

Schedule of Investments – University of California – Foreign Currency Risk
June 30, 2005
(amounts in thousands of U.S. dollars at fair value)

Currency	Equity	Fixed Income	Total
Australian Dollar	$ 46,883	$ —	$ 46,883
British Pound Sterling	126,415	—	126,415
Canadian Dollar	17,571	10,423	27,994
Danish Krone	37,803	—	37,803
Euro	414,782	—	414,782
Hong Kong Dollar	18,773	—	18,773
Japanese Yen	97,478	—	97,478
New Zealand Dollar	13,261	—	13,261
Norwegian Krone	22,671	—	22,671
Singapore Dollar	125,039	—	125,039
South African Rand	3,124	—	3,124
Swedish Krona	42,814	—	42,814
Swiss Franc	42,756	—	42,756
Other	11,850	—	11,850
Various denominations	273,715	—	273,715
Total exposure to foreign currency risk	**$ 1,294,935**	**$ 10,423**	**$ 1,305,358**

NOTE 4: ACCOUNTS RECEIVABLE

Table 17 presents the disaggregation of accounts receivable attributable to taxes, interest expense reimbursements, Lottery retailer collections, and unemployment program receipts. Other receivables are for interest, gifts, grants, various fees, penalties, and other charges. The adjustment for the fiduciary funds represents amounts due from fiduciary funds that were reclassified as external receivables on the government-wide Statement of Net Assets.

Table 17

Schedule of Accounts Receivable
June 30, 2005
(amounts in thousands)

	Taxes	Reimbursement of Accrued Interest Expense	Lottery Retailers	Unemployment Programs	Other	Total
Current governmental activities						
General Fund	$ 7,328,696	$ —	$ —	$ —	$ 444,810	$ 7,773,506
Federal Fund	—	—	—	—	6,530	6,530
Transportation Construction Fund	310,523	—	—	—	85,594	396,117
Nonmajor governmental funds	140,900	—	—	—	1,145,961	1,286,861
Internal service funds	—	—	—	—	81,255	81,255
Adjustment:						
Fiduciary funds	—	—	—	—	2,472	2,472
Total current governmental activities	**$ 7,780,119**	**$ —**	**$ —**	**$ —**	**$ 1,766,622**	**$ 9,546,741**
Amounts not scheduled for collection during the subsequent year	**$ 1,097,109**	**$ —**	**$ —**	**$ —**	**$ —**	**$ 1,097,109**
Current business-type activities						
Water Resources Fund	—	—	—	—	96,697	96,697
Public Buildings Construction Fund	—	127,542	—	—	—	127,542
State Lottery Fund	—	—	152,718	—	—	152,718
Unemployment Programs Fund	—	—	—	143,264	—	143,264
Nonmajor enterprise funds	—	—	—	—	59,285	59,285
Adjustment:						
Account reclassification	—	(127,542)	—	—	(8,258)	(135,800)
Total current business-type activities	**$ —**	**$ —**	**$ 152,718**	**$ 143,264**	**$ 147,724**	**$ 443,706**
Amounts not scheduled for collection during the subsequent year	**$ —**	**$ —**	**$ —**	**$ 43,357**	**$ —**	**$ 43,357**

NOTE 5: RESTRICTED ASSETS

Table 18 presents a summary of the legal restrictions placed on assets in the enterprise funds of the primary government and the discretely presented component units.

Table 18

Schedule of Restricted Assets
June 30, 2005
(amounts in thousands)

	Cash and Pooled Investments	Investments	Due From Other Governments	Loans Receivable	Total
Primary government					
Debt service	$ 1,529,180	$ 659,171	$ 62,434	$ 627,588	$ 2,878,373
Construction	213,503	—	—	—	213,503
Operations	1,942,008	—	—	—	1,942,008
Other	18,514	—	—	—	18,514
Total primary government	**3,703,205**	**659,171**	**62,434**	**627,588**	**5,052,398**
Discretely presented component units					
Nonmajor component units – debt service	147,021	68,700	—	—	215,721
Total discretely presented component units	**147,021**	**68,700**	**—**	**—**	**215,721**
Total restricted assets	**$ 3,850,226**	**$ 727,871**	**$ 62,434**	**$ 627,588**	**$ 5,268,119**

NOTE 6: NET INVESTMENT IN DIRECT FINANCING LEASES

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. Payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board.

Table 19 summarizes the minimum lease payments to be received by the State Public Works Board for the primary government.

Table 19

Schedule of Minimum Lease Payments to Be Received by the State Public Works Board for the Primary Government

(amounts in thousands)

Year Ending June 30	Primary Government Agencies	University of California	Local Agencies	Total
2006	$ 443,176	$ 125,588	$ 60,495	$ 629,259
2007	405,509	124,651	59,912	590,072
2008	403,789	124,882	60,133	588,804
2009	397,145	122,896	59,842	579,883
2010	380,441	115,539	59,055	555,035
2011-2015	1,713,496	570,861	268,082	2,552,439
2016-2020	1,401,341	390,466	111,210	1,903,017
2020-2025	606,453	197,119	9,107	812,679
2026-2030	235,222	50,991	7,278	293,491
2031-2035	3,633	—	—	3,633
Total minimum lease payments	**5,990,205**	**1,822,993**	**695,114**	**8,508,312**
Less: unearned income	2,250,463	669,858	201,784	3,122,105
Net investment in direct financing leases	**$ 3,739,742**	**$ 1,153,135**	**$ 493,330**	**$ 5,386,207**

NOTE 7: CAPITAL ASSETS

Table 20 summarizes the capital activity for the primary government, which includes $5.0 billion in capital assets related to capital leases.

Table 20

Schedule of Changes in Capital Assets – Primary Government
June 30, 2005
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Governmental activities				
Capital assets not being depreciated				
Land	$ 14,383,694	$ 351,326	$ 4,970	$ 14,730,050
State highway infrastructure	54,467,725	647,157	—	55,114,882
Collections	32,395	1,422	14,463	19,354
Construction in progress	4,783,191	1,836,096	990,824	5,628,463
Total capital assets not being depreciated	**73,667,005**	**2,836,001**	**1,010,257**	**75,492,749**
Capital assets being depreciated				
Buildings and improvements	14,723,120	841,919	274,996	15,290,043
Infrastructure	377,175	34,283	1,755	409,703
Equipment and other assets	3,918,992	250,889	181,711	3,988,170
Total capital assets being depreciated	**19,019,287**	**1,127,091**	**458,462**	**19,687,916**
Less accumulated depreciation for:				
Buildings and improvements	4,459,053	549,979	182,888	4,826,144
Infrastructure	119,147	12,237	4,009	127,375
Equipment and other assets	2,860,582	352,925	164,711	3,048,796
Total accumulated depreciation	**7,438,782**	**915,141**	**351,608**	**8,002,315**
Total capital assets being depreciated, net	**11,580,505**	**211,950**	**106,854**	**11,685,601**
Governmental activities, capital assets, net	**$ 85,247,510**	**$ 3,047,951**	**$ 1,117,111**	**$ 87,178,350**
Business-type activities				
Capital assets not being depreciated				
Land	$ 23,256	$ 22,526	$ —	$ 45,782
Construction in progress	1,426,442	319,143	132,920	1,612,665
Total capital assets not being depreciated	**1,449,698**	**341,669**	**132,920**	**1,658,447**
Capital assets being depreciated				
Buildings and improvements	6,450,929	272,054	14,752	6,708,231
Infrastructure	1,205,235	3,023	—	1,208,258
Equipment and other assets	102,595	11,641	32,328	81,908
Total capital assets being depreciated	**7,758,759**	**286,718**	**47,080**	**7,998,397**
Less accumulated depreciation for:				
Buildings and improvements	2,404,882	141,156	30,570	2,515,468
Infrastructure	657,798	19,253	—	677,051
Equipment and other assets	75,582	8,815	30,559	53,838
Total accumulated depreciation	**3,138,262**	**169,224**	**61,129**	**3,246,357**
Total capital assets being depreciated, net	**4,620,497**	**117,494**	**(14,049)**	**4,752,040**
Business-type activities, capital assets, net	**$ 6,070,195**	**$ 459,163**	**$ 118,871**	**$ 6,410,487**

Table 21 summarizes the depreciation expense charged to the activities of the primary government.

Table 21

Schedule of Depreciation Expense – Primary Government
June 30, 2005
(amounts in thousands)

	Amount
Governmental activities	
General government	$ 72,085
Education	365,004
Health and human services	31,910
Resources	45,213
State and consumer services	34,412
Business and transportation	88,600
Correctional programs	152,726
Internal service funds (charged to the activities that utilize the fund)	125,191
Total depreciation expense – governmental activities	**915,141**
Business-type activities	
Enterprise	**169,224**
Total primary government	**$ 1,084,365**

Table 22 summarizes the capital activity for discretely presented component units.

Table 22

Schedule of Changes in Capital Assets – Discretely Presented Component Units
June 30, 2005
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Capital assets not being depreciated				
Land	$ 537,897	$ 60,989	$ 589	$ 598,297
Collections	236,478	14,126	159	250,445
Construction in progress	3,066,197 *	362,254	69,019	3,359,432
Total capital assets not being depreciated	**3,840,572**	**437,369**	**69,767**	**4,208,174**
Capital assets being depreciated				
Buildings and improvements	14,134,230 *	1,542,731	54,327	15,622,634
Equipment and other depreciable assets	7,602,173 *	626,607	687,315	7,541,465
Infrastructure	360,821	6,096	784	366,133
Total capital assets being depreciated	**22,097,224**	**2,175,434**	**742,426**	**23,530,232**
Less accumulated depreciation for:				
Buildings and improvements	5,269,837 *	549,656	13,741	5,805,752
Equipment and other depreciable assets	5,069,141 *	540,695	636,627	4,973,209
Infrastructure	153,985	11,326	784	164,527
Total accumulated depreciation	**10,492,963**	**1,101,677**	**651,152**	**10,943,488**
Total capital assets being depreciated, net	**11,604,261**	**1,073,757**	**91,274**	**12,586,744**
Capital assets, net	**$ 15,444,833**	**$ 1,511,126**	**$ 161,041**	**$ 16,794,918**

* Restated

NOTE 8: ACCOUNTS PAYABLE

Accounts payable are amounts due to taxpayers, vendors, customers, beneficiaries, and employees related to different programs. Table 23 presents details related to the accounts payable.

The adjustment for the fiduciary funds represents amounts due to fiduciary funds that were reclassified as external payables on the government-wide Statement of Net Assets.

Table 23

Schedule of Accounts Payable
June 30, 2005
(amounts in thousands)

	Education	Health and Human Services	Resources	Business and Transportation	General Government and Others	Total
Governmental activities						
General Fund	$ 527,345	$ 55,338	$ 87,217	$ 1,420	$ 550,191	$ 1,221,511
Federal Fund	598,126	392,999	58,029	162,084	96,778	1,308,016
Transportation Construction Fund	90	—	—	129,501	7,384	136,975
Nonmajor governmental funds	315,607	554,116	296,574	1,088,693	490,096	2,745,086
Internal service funds	—	71,391	23,106	10,851	72,647	177,995
Adjustment:						
Fiduciary funds	3,157,726	2,994,295	—	37,974	597,952	6,787,947
Total governmental activities	**$ 4,598,894**	**$ 4,068,139**	**$ 464,926**	**$ 1,430,523**	**$ 1,815,048**	**$ 12,377,530**
Business-type activities						
Electric Power Fund	$ —	$ —	$ 424,000	$ —	$ —	$ 424,000
Water Resources Fund	—	—	48,206	—	—	48,206
Public Building Construction Fund	—	—	—	—	4,692	4,692
State Lottery Fund	—	—	—	—	36,193	36,193
Unemployment Program Fund	—	7	—	—	—	7
Nonmajor enterprise funds	16,288	5,825	11	1,566	3,675	27,365
Adjustment:						
Fiduciary funds	—	6,129	—	—	—	6,129
Total business-type activities	**$ 16,288**	**$ 11,961**	**$ 472,217**	**$ 1,566**	**$ 44,560**	**$ 546,592**

NOTE 9: SHORT-TERM FINANCING

As part of its cash management program, the State regularly issues short-term obligations to meet cash flow needs. The State issues revenue anticipation notes (RANs) to partially fund timing differences between revenues and expenditures. A significant portion of the General Fund revenues are received in the latter half of the fiscal year, while disbursements are paid more evenly throughout the fiscal year. If additional external cash flow borrowing is required, the State issues revenue anticipation warrants (RAWs). On October 6, 2004, the State issued $6.0 billion of RANs, to fund cash flow needs for the 2004-05 fiscal year. The RANs were repaid on June 30, 2005.

The California Housing Finance Agency, a discretely presented component unit, entered into an agreement with a financial institution to provide a line of credit for short-term borrowings of up to $100 million, which may increase up to $150 million. At June 30, 2005, draws totaling $39 million were outstanding.

NOTE 10: LONG-TERM OBLIGATIONS

As of June 30, 2005, the primary government had long-term obligations totaling $97.2 billion. Of that amount, $4.9 billion is due within one year. The $4.9 billion includes $494 million in outstanding commercial paper that had been scheduled to be refunded by general obligation bonds issued during the fiscal year. This commercial paper was refunded in July and August 2005. Governmental activities general obligation bonds payable increased because bond sales exceeded redemptions during the year.

The other long-term obligations for governmental activities consist of $2.8 billion for workers' compensation claims, $2.3 billion for reimbursement of costs mandated by the State, $1.4 billion for outstanding debts to schools related to the Proposition 98 funding guarantee, $1.1 billion for net pension obligations, $428 million owed for lawsuits, and the University of California unfunded pension liability of $79 million. The compensated absences will be liquidated by the General Fund, special revenue funds, capital projects funds, and internal service funds. Workers' compensation and capital leases will be liquidated by the General Fund, special revenue funds, and internal service funds. The General Fund will liquidate loans payable, net pension obligations, the Proposition 98 funding guarantee, lawsuits, reimbursement of costs incurred by local agencies and school districts for costs mandated by the State, and the University of California pension liability. The $548 million in other long-term obligations for business-type activities is mainly for advance collections. These other long-term obligations do not have required payment schedules, or they will be paid when funds are appropriated. Table 24 summarizes the changes in the long-term obligations during the year ended June 30, 2005.

Table 24

Schedule of Changes in Long-term Obligations
(amounts in thousands)

	Balance July 1, 2004	Additions	Deductions	Balance June 30, 2005	Due Within One Year	Noncurrent Liabilities
Governmental activities						
Loans payable	$ 880,226	$ 131,574	$ —	$ 1,011,800	$ —	$ 1,011,800
Compensated absences payable	1,531,399	875,941	682,377	1,724,963	101,537	1,623,426
Certificates of participation and commercial paper	849,360	2,083,488	2,180,835	752,013	505,512	246,501
Capital lease obligations	3,745,410	414,738	241,588	3,918,560	230,605	3,687,955
General obligation bonds payable	43,924,636	2,978,080	1,361,299	45,541,417	1,721,350	43,820,067
Revenue bonds payable	8,101,855	99,250	132,125	8,068,980	91,280	7,977,700
Other long-term obligations	7,740,307	907,766	457,135	8,190,938	605,131	7,585,807
Total	**$ 66,773,193**	**$ 7,490,837**	**$ 5,055,359**	**$ 69,208,671**	**$ 3,255,415**	**$ 65,953,256**
Business-type activities						
Benefits payable	$ 19,449	$ —	$ 2,858	$ 16,591	$ —	$ 16,591
Lottery prizes and annuities	2,460,663	1,944,769	2,058,767	2,346,665	582,496	1,764,169
Compensated absences payable	43,200	24,710	23,081	44,829	12,385	32,444
Certificates of participation and commercial paper	97,179	161,970	208,056	51,093	—	51,093
General obligation bonds payable	2,215,800	120,000	245,695	2,090,105	126,800	1,963,305
Revenue bonds payable	22,239,016	1,974,919	1,270,399	22,943,536	930,013	22,013,523
Other long-term obligations	564,519	289	17,097	547,711	5,305	542,406
Total	**$ 27,639,826**	**$ 4,226,657**	**$ 3,825,953**	**$ 28,040,530**	**$ 1,656,999**	**$ 26,383,531**

NOTE 11: CERTIFICATES OF PARTICIPATION

Table 25 shows debt service requirements for certificates of participation, which are financed by lease payments from governmental activities. The certificates of participation were used to finance the acquisition and construction of state office buildings.

Table 25

Schedule of Debt Service Requirements for Certificates of Participation – Primary Government
(amounts in thousands)

Year Ending June 30	Principal	Interest	Total
2006	$ 11,312	$ 2,893	$ 14,205
2007	6,579	3,059	9,638
2008	6,292	3,350	9,642
2009	6,099	3,539	9,638
2010	6,042	3,599	9,641
2011-2015	35,574	12,633	48,207
2016-2020	11,915	626	12,541
Total	**$ 83,813**	**$ 29,699**	**$ 113,512**

Table 26 shows debt service requirements for certificates of participation for the University of California, a discretely presented component unit.

Table 26

Schedule of Debt Service Requirements for Certificates of Participation – University of California – Discretely Presented Component Unit

(amounts in thousands)

Year Ending June 30	Principal	Interest	Total
2006	$ 7,270	$ 6,766	$ 14,036
2007	7,640	6,391	14,031
2008	8,020	6,002	14,022
2009	8,490	5,597	14,087
2010	8,980	5,162	14,142
2011-2015	20,010	21,780	41,790
2016-2020	18,245	17,213	35,458
2021-2025	22,270	12,086	34,356
2026-2030	28,775	5,404	34,179
2031-2035	5,520	293	5,813
Total	**$ 135,220**	**$ 86,694**	**$ 221,914**

NOTE 12: COMMERCIAL PAPER AND OTHER LONG-TERM BORROWINGS

The primary government has three commercial paper borrowing programs: a general obligation commercial paper program, an enterprise fund commercial paper program for the Department of Water Resources, and a toll bridges seismic retrofit commercial paper program. Under the general obligation and enterprise fund programs, commercial paper may be issued at prevailing rates for periods not to exceed 270 days from the date of issuance. Under the toll bridges seismic retrofit program, commercial paper may be issued at interest rates determined by the State Treasurer or applicable dealer for period not to exceed 90 days from the date of issuance. The proceeds from the issuance of commercial paper are restricted primarily for construction costs of general obligation bond program projects, certain state water projects, and seismic retrofit projects on State-owned toll bridges. For all three commercial paper borrowing programs, the commercial paper is retired by the issuance of long-term debt, so it is considered a noncurrent liability.

To provide liquidity for the programs, the State has entered into revolving credit agreements with commercial banks. The current agreement for the general obligation commercial paper program, effective December 1, 2004, authorizes the issuance of notes in an aggregate principal amount not to exceed $1.5 billion. The current agreement for the enterprise fund commercial paper program authorizes the issuance of notes in an aggregate principal amount not to exceed $141.5 million. The current agreement for the toll bridges seismic retrofit commercial paper program, effective March 1, 2005, authorizes the issuance of notes in an aggregate principal amount not to exceed $400 million. As of June 30, 2005, the enterprise fund commercial paper program had $12 million in outstanding notes and the toll bridges seismic retrofit commercial paper program had $80 million in outstanding notes.

During the year ended June 30, 2005, the primary government issued $2.0 billion in general obligation commercial paper and $2.4 billion in long-term general obligation bonds to refund outstanding commercial paper. However, by June 30, 2005, only $1.9 billion of the $2.4 billion had been used to repay outstanding commercial paper. The remaining $494 million was used to repay commercial paper in July and August 2005.

As of June 30, 2005, the general obligation commercial paper program had $588 million in outstanding commercial paper notes, of which $494 million is considered a current liability.

The primary government has a revenue bond anticipation note (BAN) program that consists of borrowing for capital improvements on certain campuses of the California State University. As of June 30, 2005, $39 million in outstanding BANs existed in anticipation of issuing revenue bonds to the public.

The University of California, a discretely presented component unit, has other borrowings consisting of contractual obligations resulting from the acquisition of land or buildings and the construction and renovation of certain facilities. Included in other borrowings, which total approximately $311 million, are various unsecured financing agreements, totaling approximately $135 million, with commercial banks.

The University of California established a $550 million commercial paper program with tax-exempt and taxable components. The program is supported by the legally available unrestricted investments balance in the University of California's Short-Term Investment Pool. Commercial paper has been issued by the University to provide for interim financing of the construction, renovation, and acquisition of certain facilities and equipment. Commercial paper is secured by a pledge of the net revenues generated by the enterprise financed, not by any encumbrance, mortgage, or other pledge of property, and does not constitute a general obligation of the University of California. At June 30, 2005, outstanding tax-exempt and taxable commercial paper was $430 million and $120 million, respectively.

NOTE 13: LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30, 2005, was approximately $7.1 billion. Primary government leases that are classified as operating leases, in accordance with the applicable standards, contain clauses providing for termination. Operating lease expenditures are recognized as being incurred over the lease term. It is expected that, in the normal course of business, most of these operating leases will be replaced by similar leases.

The total present value of minimum capital lease payments for the primary government is composed of $5 million from internal service funds and $3.9 billion from other governmental activities. Note 10, Long-term Obligations, reports the additions and deductions of capital lease obligations. Also reported in Note 10 are the current and noncurrent portions of the capital lease obligations. Lease expenditures for the year ended June 30, 2005, amounted to approximately $783 million.

Included in the capital lease commitments are lease-purchase agreements that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency, amounting to a present value of net minimum lease payments of $3.7 billion. This amount represents 95% of the total present value of minimum lease payments of the primary government. Also included in the capital lease commitments are some lease-purchase agreements to acquire equipment.

The capital lease commitments do not include $683 million of lease-purchase agreements with building authorities that are blended component units. These building authorities acquire or develop office buildings and then lease the facilities to state agencies. Upon expiration of the lease, title passes to the primary government. The costs of the buildings and the related outstanding revenue bonds and certificates of participation are reported in the government-wide financial statements. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements.

Table 27 summarizes future minimum lease commitments of the primary government.

Table 27

Schedule of Future Minimum Lease Commitments – Primary Government
(amounts in thousands)

Year Ending June 30	Operating Leases	Capital Leases: Internal Service Funds	Capital Leases: Other Governmental Activities	Total
2006	$ 243,534	$ 1,221	$ 485,425	$ 730,180
2007	181,879	791	435,714	618,384
2008	136,637	791	429,894	567,322
2009	95,326	794	418,725	514,845
2010	48,621	834	398,277	447,732
2011-2015	108,516	1,599	1,775,347	1,885,462
2016-2020	30,594	—	1,450,151	1,480,745
2021-2025	251	—	639,948	640,199
2026-2030	—	—	235,222	235,222
2031-2035	—	—	3,633	3,633
Total minimum lease payments	**$ 845,358**	**6,030**	**6,272,336**	**$ 7,123,724**
Less: amount representing interest		943	2,358,863	
Present value of net minimum lease payments		**$ 5,087**	**$ 3,913,473**	

The aggregate amount of discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 2005, was approximately $3.4 billion. Table 28 presents the future minimum lease commitments for the University of California and the State Compensation Insurance Fund. Operating lease expenditures for the year ended June 30, 2005, amounted to approximately $222 million for discretely presented component units.

Table 28

Schedule of Future Minimum Lease Commitments – Discretely Presented Component Units
(amounts in thousands)

Year Ending June 30	University of California Capital	University of California Operating	State Compensation Insurance Fund Operating	Total
2006	$ 191,211	$ 88,361	$ 47,726	$ 327,298
2007	189,283	73,200	37,524	300,007
2008	182,837	58,668	30,802	272,307
2009	185,916	46,154	20,898	252,968
2010	156,248	30,285	18,741	205,274
2011-2015	762,505	47,311	30,763	840,579
2016-2020	598,901	3,836	—	602,737
2021-2025	404,679	3,540	—	408,219
2026-2030	225,793	3,978	—	229,771
2031-2035	—	4,531	—	4,531
2036-2040	—	4,657	—	4,657
Total minimum lease payments	**2,897,373**	$ **364,521**	$ **186,454**	**$ 3,448,348**
Less: amount representing interest	1,013,945			
Present value of net minimum lease payments	**$ 1,883,428**			

NOTE 14: COMMITMENTS

As of June 30, 2005, the primary government had commitments of $4.0 billion for certain highway construction projects. These commitments are not included in the reserve for encumbrances in the Federal Fund and the Transportation Construction Fund because the future expenditures related to these commitments will be reimbursed with $788 million from local governments and $3.2 billion in proceeds of approved federal grants. The ultimate liability will not accrue to the State.

The primary government had other commitments, totaling $32.0 billion, that are not included as a liability on the Balance Sheet or the Statement of Net Assets. These commitments included $13.4 billion in long-term contracts to purchase power; these contracts are not included as a liability on the Statement of Net Assets of the Electric Power Fund. In addition, variable costs, estimated at $10.6 billion by management, are associated with several of the contracts. Purchases will take place in the future, and the commitments will be met with future receipts from charges to residential and commercial energy users. The $32.0 billion in commitments also included grant agreements, totaling approximately $6.3 billion, to reimburse other entities for construction projects for school building aid, parks, and other improvements. The constructed buildings will not belong to the primary government, whose payments are contingent upon the other entities entering into construction contracts.

In addition to the grant commitments, the primary government had commitments of approximately $1.5 billion for the construction of water projects and the purchase of power, and $217 million for the maintenance and operation of the California State Lottery's automated gaming system and its communication systems and services. These are long-term projects, and all of the contracts' needs may not have been defined. The projects will be funded with existing and future program resources or with the proceeds of revenue and general obligation bonds.

As of June 30, 2005, the discretely presented component units had other commitments that are not included as liabilities on the Statement of Net Assets. The University of California had authorized construction projects totaling $3.1 billion. The university also made commitments to make investments in certain investment partnerships pursuant to provisions in the partnership agreements. These commitments totaled $1.2 billion as of June 30, 2005. Other component units had outstanding commitments to provide $628 million for loans under various housing revenue bond programs and $20 million to other governments for infrastructure improvements.

NOTE 15: GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds majority 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; it can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service it provides on their behalf. General obligation bonds that are directly related to, and are expected to be paid from, the resources of enterprise funds are included as a liability of such funds in the 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.

As of June 30, 2005, the State had $45.5 billion in outstanding general obligation bonds related to governmental activities and $2.1 billion related to business-type activities. In addition, $35.2 billion of general obligation bonds were authorized but not issued. This amount includes $19.8 billion that was authorized by the applicable finance committee for future issuance in the form of commercial paper notes. Of this amount, $588 million in general obligation indebtedness was issued in the form of commercial paper notes but was not yet retired by long-term bonds.

Note 10, Long-term Obligations, discusses the change to general obligation bonds payable.

A. Variable-rate General Obligation Bonds

As part of the *Strategic Debt Management Plan* adopted in the 2001-02 fiscal year, the State has issued variable-rate general obligation bonds. Prior to the 2004-05 fiscal year, the State had $1.4 billion of variable-rate general obligation bonds outstanding consisting of $250 million in daily rate, $650 million in weekly rate, and $500 million in auction rate. On October 20, 2004, the State sold an additional $1.0 billion of variable-rate general obligation bonds consisting of $590 million in daily rate and $410 million in weekly rate.

The interest rates associated with the daily rates and weekly rates are determined by the remarketing agents to be the lowest rate that would allow the bonds to sell on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest is paid on the first business day of each calendar month. The interest rates on the auction-rate bonds are determined by the auction agent through an auction process and the interest is paid on the business day immediately following each auction rate period.

Letters of credit were issued to secure payment of principal and interest on the daily and weekly variable-rate bonds. Under these letters of credit, the credit providers pay all principal and interest payments to the bondholders; the State is then required to reimburse the credit providers for the amounts paid. Different credit providers exist for each series of variable-rate bonds issued. For the variable-rate bonds issued prior to the 2004-05 fiscal year, the initial expiration dates of the letters of credit for the daily and weekly variable-rate

bonds are April 14, 2008, and April 14, 2006, respectively. For the variable-rate bonds issued during the 2004-05 fiscal year, the initial expiration date of the letters of credit is October 20, 2009.

Sinking fund deposits for the variable-rate general obligation bonds will be set aside in a mandatory sinking fund at the beginning of each fiscal year, starting in the 2015-16 fiscal year and continuing to the 2033-34 fiscal year, based on the schedules provided in the Official Statements. The deposits set aside in any fiscal year may be applied, with approval of the State Treasurer and the appropriate bond finance committees, to the redemption of any other general obligation bonds then outstanding. To the extent that the deposit is not applied by January 31 of each fiscal year, the variable-rate general obligation bonds will be redeemed in whole or in part on an interest payment date in that fiscal year.

B. Economic Recovery Bonds

On March 2, 2004, voters approved the one-time issuance of up to $15 billion in Economic Recovery Bonds; during the 2003-04 fiscal year, the State sold a total of $10.9 billion of these bonds. The debt service for these bonds is payable from and secured by amounts available in the Fiscal Recovery Fund, a special revenue fund, that consists primarily of revenues from a dedicated sales tax. However, the General Fund may be liable for the payment of any principal and interest on the bonds that cannot be paid from the Fiscal Recovery Fund.

As of June 30, 2005, the State still had $10.9 billion of Economic Recovery Bonds outstanding. Of the $10.9 billion outstanding, bonds totaling $3.0 billion are variable rate bonds, consisting of $1.0 billion in daily rate and $2.0 billion in weekly rate. The interest rates associated with the daily rates and weekly rates are determined by the remarketing agents to be the lowest rate that would enable them to sell the bonds for delivery on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest is paid on the first business day of each calendar month. As described in the Official Statement, payment of principal, interest, and purchase price upon tender, for a portion of these bonds, is secured by a direct-pay letter of credit. Payment of principal and interest for another portion of these bonds is secured by a bond insurance policy, together with an insured standby bond purchase agreement upon tender. A separate uninsured standby bond purchase agreement supports the purchase upon tender for the final portion of these bonds, without credit enhancement in the form of an insurance policy or letter of credit related to the payment of principal or interest. The State reimburses its credit providers for any amounts paid, plus interest. Different credit providers exist for each series of variable-rate bonds issued. The initial expiration dates for these letters of credit, bond insurance policies, and standby bond purchase agreements fall between June 15, 2007, and December 31, 2015.

Another $1.0 billion of the $10.9 billion Economic Recovery Bonds outstanding have interest-reset dates of either July 1, 2007, or July 1, 2008. At that time, the bonds are subject to mandatory tender for purchase at a price equal to 100% of the principal amount, plus accrued interest, without premium. Upon mandatory tender, the State will seek to remarket these bonds. The debt service requirements published in the Official Statement differ from the calculation included in Table 29, because the statement presumes a successful remarketing at an interest rate of 3.33% per year, along with the creation of a mandatory sinking fund. The debt service calculation in Table 29 uses the interest rates in effect at year-end, which are the same interest rates in effect until the applicable reset date, and does not assume the future establishment of a sinking fund. In the event of a failed remarketing, the State is required to return all tendered bonds to their initial purchasers and pay an annual interest rate of 11% until there is a successful remarketing of these bonds.

C. Debt Service Requirements

Table 29 shows the debt service requirements for all general obligation bonds as of June 30, 2005. The estimated debt service requirements for the $2.4 billion variable-rate general obligation bonds and the $3.0 billion variable-rate Economic Recovery Bonds are calculated using the actual interest rates in effect on June 30, 2005.

Table 29

Schedule of Debt Service Requirements for General Obligation Bonds
(amounts in thousands)

Year Ending June 30	Governmental Activities			Business-type Activities		
	Principal	Interest	Total	Principal	Interest	Total
2006	$ 1,721,350	$ 2,153,745	$ 3,875,095	$ 126,800	$ 117,283	$ 244,083
2007	1,729,850	2,063,487	3,793,337	129,360	106,440	235,800
2008	1,923,362	1,974,518	3,897,880	136,430	96,618	233,048
2009	2,050,965	1,873,942	3,924,907	135,340	86,830	222,170
2010	2,168,750	1,765,175	3,933,925	118,190	77,557	195,747
2011-2015	8,677,600	7,274,192	15,951,792	502,750	305,517	808,267
2016-2020	8,580,120	5,241,286	13,821,406	481,080	176,307	657,387
2021-2025	8,425,260	3,508,387	11,933,647	172,210	98,649	270,859
2026-2030	6,829,030	1,768,829	8,597,859	143,720	58,973	202,693
2031-2035	3,435,130	354,977	3,790,107	128,225	17,201	145,426
2036-2040	—	—	—	16,000	858	16,858
Total	**$ 45,541,417**	**$ 27,978,538**	**$ 73,519,955**	**$ 2,090,105**	**$ 1,142,233**	**$ 3,232,338**

D. General Obligation Bond Defeasances

1. Current Year

On February 16, 2005, the primary government issued $794 million in various-purpose general obligation refunding bonds to current- and advance-refund $804 million in general obligation bonds maturing in 2009 and 2012 to 2029. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered defeased and the liability for those bonds has been removed from the financial statements. The refunding decreased overall debt service payments by $118 million and resulted in an economic gain of $75 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 4.1% per year over the life of the new bonds.

On April 6, 2005, the primary government issued $764 million in various-purpose general obligation refunding bonds to advance-refund $752 million in general obligation bonds maturing in 2011 to 2030. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for those bonds has been removed from the financial statements. This advance refunding reduced debt service payments by $74 million and resulted in an economic gain of $46 million, using a discount rate of 4.3%.

On April 12, 2005, the primary government issued $221 million in veterans general obligation bonds, the proceeds of which were used to immediately refund $101 million in outstanding general obligation bonds

maturing in years 2011 to 2018. This refunding reduced debt service payments by $14 million and resulted in an economic gain of $9 million, using a discount rate of 3.0%.

On June 16, 2005, the primary government issued $380 million in various–purpose general obligation refunding bonds to advance-refund $380 million in general obligation bonds maturing in 2014 to 2029. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for the bonds has been removed from the financial statements. This advance refunding reduced debt service payments by $34 million and resulted in an economic gain of $21 million, using a discount rate of 4.2%.

2. Prior Years

In prior years, the primary government placed the proceeds of the refunding bonds in a special irrevocable escrow trust account with the State Treasury to provide for all future debt service payments on defeased bonds. The assets of the trust accounts and the liability for defeased bonds are not included in the State's financial statements. As of June 30, 2005, the outstanding balance of general obligation bonds defeased in prior years was approximately $741 million.

NOTE 16: REVENUE BONDS

A. Governmental Activities

The California Infrastructure and Economic Development Bank is authorized by state law to issue Bay Area Toll Bridges Seismic Retrofit Revenue Bonds. The purpose of these bonds is to finance a portion of the seismic retrofitting of some of the toll bridges owned by the State that serve the Bay Area. These bonds are secured and payable from a $1 per vehicle seismic surcharge from all toll-paying vehicles on the Bay Area bridges. The State Treasurer is authorized by state law to issue Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds). The purpose of these bonds is to accelerate the funding and construction of critical transportation infrastructure projects in order to provide congestion relief benefits to the public significantly sooner than with traditional funding mechanisms. These bonds are secured and payable from the annual federal appropriation for the State's federal-aid transportation projects. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. Both of these bonds fund activities in the Transportation Construction Fund and are included in the governmental activities column of the government-wide Statement of Net Assets.

The California State University, Channel Islands Financing Authority, a blended component unit in the California State University Programs Fund, issues revenue bonds to provide funding for public capital improvements serving the California State University, Channel Islands. These bonds are secured and payable from special taxes, tax increment revenues, and pledged rental housing revenues of the California State University, Channel Islands Site Authority, which is also a blended component unit in the California State University Programs Fund. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. The bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

The Golden State Tobacco Securitization Corporation (GSTSC), a blended component unit, is authorized by state law to issue asset-backed bonds to purchase the State's rights to future revenues from the Master Settlement Agreement with participating tobacco companies. These bonds are secured by and payable solely from future Tobacco Settlement Revenue. The primary government has no legal liability for the payment of

principal and interest on these bonds. These bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

Under state law, certain building authorities may issue revenue bonds. These bonds are issued for the purpose of acquiring and constructing buildings for public education purposes and for the purpose of constructing state office buildings. Leases with state agencies pay the principal and interest on the revenue bonds issued by the building authorities. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. These revenue bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

B. Business-type Activities

Revenue bonds that are directly related to, and are expected to be paid from, the resources of enterprise funds are included in the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of agencies that issued the bonds. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

Revenue bonds to acquire, construct, or renovate state facilities or to refund outstanding revenue bonds in advance of maturity are issued for water resources, public building construction, and certain nonmajor enterprise funds. Revenue bonds were used to repay advances from the General Fund and loans from financial institutions that were used to finance electric power purchases for resale to utility customers.

C. Discretely Presented Component Units

The University of California issues revenue bonds to finance the construction, renovation, and acquisition of certain facilities and equipment.

Under state law, the California Housing Finance Agency (CalHFA) issues fixed- and variable-rate revenue bonds to make loans to finance housing developments and to finance the acquisition of homes by low- and moderate-income families. Variable-rate debt is typically tied to a common index, such as the Bond Market Association (BMA) or the London Interbank Offered Rate (LIBOR) and is reset periodically.

Table 30 shows revenue bonds outstanding of the primary government and the discretely presented component units.

Table 30

Schedule of Revenue Bonds Outstanding
June 30, 2005
(amounts in thousands)

Primary government		
Governmental activities		
Transportation Construction Fund	$	1,733,740
Nonmajor governmental funds		
California State University Programs Fund		195,525
Golden State Tobacco Securitization Corporation Fund		5,456,205
Building authorities		683,510
Total governmental activities		**8,068,980**
Business-type activities		
Electric Power Fund		10,982,000
Water Resources Fund		2,425,201
Public Building Construction Fund		6,697,293
Nonmajor enterprise funds		2,839,042
Total business-type activities		**22,943,536**
Total primary government		**31,012,516**
Discretely presented component units		
University of California		5,065,850
California Housing Finance Agency		7,500,766
Nonmajor component units		508,765
Total discretely presented component units		**13,075,381**
Total	**$**	**44,087,897**

Table 31 shows the debt service requirements for fixed- and variable-rate bonds. It excludes certain unamortized refunding costs, premiums, discounts, and other costs that are included in Table 30.

Table 31

Schedule of Debt Service Requirements for Revenue Bonds
(amounts in thousands)

Year Ending June 30	Primary Government				Discretely Presented Component Units	
	Governmental Activities		Business-type Activities			
	Principal	Interest	Principal	Interest*	Principal	Interest*
2006	$ 91,280	$ 452,127	$ 883,873	$ 1,025,627	$ 1,227,505	$ 450,622
2007	112,305	449,206	893,501	986,833	308,846	422,528
2008	177,220	444,301	934,145	945,333	344,018	407,833
2009	139,895	438,247	985,429	906,588	364,086	391,677
2010	144,635	431,900	1,004,080	861,189	407,049	376,154
2011-2015	726,760	2,054,761	5,613,476	3,514,833	1,919,507	1,600,157
2016-2020	624,280	1,897,144	6,571,716	2,057,603	2,065,685	1,184,756
2021-2025	846,155	1,723,048	3,903,378	816,985	2,002,792	816,297
2026-2030	1,033,110	1,605,192	1,555,993	266,250	2,071,970	483,822
2031-2035	1,468,745	1,310,272	280,760	43,565	1,614,728	209,035
2036-2040	1,811,140	829,695	47,112	1,789	585,503	47,090
2041-2045	893,455	187,972	—	—	12,960	403
Total	**$ 8,068,980**	**$ 11,823,865**	**$ 22,673,463**	**$ 11,426,595**	**$ 12,924,649**	**$ 6,390,374**

*Includes interest on variable-rate bonds based on rates in effect on June 30, 2005.

Table 32 shows debt service requirements as of June 30, 2005, for variable-rate debt included in Table 31, as well as net swap payments, assuming that current interest rates remain the same for their term. As interest rates vary, variable-rate bond interest payments and net swap payments will vary.

Table 32

Schedule of Debt Service and Swap Requirements for Variable-rate Revenue Bonds
(amounts in thousands)

	Primary Government				Discretely Presented Component Units			
	Business-type Activities							
Year Ending June 30	Principal	Interest*	Interest Rate* Swap Net	Total	Principal	Interest*	Interest Rate* Swap Net	Total
2006	$ —	$ 33,000	$ 14,000	$ 47,000	$ 79,210	$ 108,052	$ 93,030	$ 280,292
2007	—	33,000	14,000	47,000	94,395	110,471	93,410	298,276
2008	—	33,000	14,000	47,000	112,845	105,235	89,099	307,179
2009	—	33,000	14,000	47,000	118,250	99,242	83,306	300,798
2010	—	33,000	14,000	47,000	121,475	92,904	77,157	291,536
2011-2015	1,026,000	119,000	55,000	1,200,000	664,890	377,791	310,255	1,352,936
2016-2020	404,000	14,000	7,000	425,000	813,355	250,123	205,324	1,268,802
2021-2025	—	—	—	—	918,975	156,590	129,982	1,205,547
2026-2030	—	—	—	—	1,031,060	83,404	71,200	1,185,664
2031-2035	—	—	—	—	816,385	27,226	23,152	866,763
2036-2040	—	—	—	—	98,925	2,409	2,153	103,487
Total	**$ 1,430,000**	**$ 298,000**	**$ 132,000**	**$ 1,860,000**	**$ 4,869,765**	**$ 1,413,447**	**$ 1,178,068**	**$ 7,461,280**

*Based on rates in effect on June 30, 2005.

D. Primary Government Variable Rate/Swap Disclosure

Objective: The Department of Water Resources (DWR) entered into interest-rate swap agreements with various counterparties to reduce variable-interest-rate risk for the Electric Power Fund. The swaps create a synthetic fixed rate. The DWR agreed to make fixed-rate payments and receive floating-rate payments on notional amounts equal to a portion of the principal amount of this variable-rate debt.

Terms and Fair Value: The terms and fair value of the swap agreements entered into by DWR, all of which became effective February 13, 2003, are summarized in Table 34. The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions to outstanding notional amounts that follow scheduled amortization of the associated debt. Most swaps had a negative fair value as of June 30, 2005, because interest rates had declined. The fair values were provided by the counterparties using either the par value or the marked-to-market method.

Credit Risk: As of June 30, 2005, DWR was not exposed to significant credit risk because the swaps had negative fair values. However, should interest rates increase and the fair values become positive, DWR would be exposed to credit risk in the amount of the swaps' fair value. The DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35% of the total notional value, are with a counterparty that has Moody's Investors Service, Fitch Ratings, and Standard & Poor's (S&P) credit ratings of Aaa, AAA, and AAA, respectively. Of the remaining swaps, two are held with a single counterparty and approximate 21% of the outstanding notional value; that counterparty has Moody's, Fitch's, and S&P's credit

ratings of Aa3, AA-, and A+, respectively. The remaining four swaps are with separate counterparties, all having Moody's, Fitch's, and S&P's credit ratings of Aa3, A+, and A+, respectively, or better. Table 33 summarizes the credit ratings of the counterparties for the swap agreements.

Table 33

Schedule of Terms, Fair Values, and Credit Ratings of Swap Agreements
(amounts in thousands)

Swap Termination Date	Outstanding Notional Amount at June 30, 2005	Fair Values at June 30, 2005	Fixed Rate Paid by Electric Power Fund	Variable Rate Received by Electric Power Fund	Counterparty Credit Ratings (Moody's, Fitch's, S&P's)
5/1/2011	$ 94,000	$ (3,000)	2.914 %	67% of LIBOR	Aaa, AAA, AAA
5/1/2012	234,000	(6,000)	3.024	67% of LIBOR	Aaa, AAA, AAA
5/1/2013	200,000	(3,000)	3.405	BMA	Aa3, A+, A+
5/1/2013	100,000	(1,000)	3.405	BMA	Aa3, AA-, A+
5/1/2013	30,000	—	3.405	BMA	Aa3, AA-, A+
5/1/2014	194,000	(5,000)	3.204	67% of LIBOR	Aa1, AA-, AA-
5/1/2015	174,000	(9,000)	3.280	67% of LIBOR	Aaa, AAA, AAA
5/1/2016	202,000	(8,000)	3.342	67% of LIBOR	Aa2, AA, AA
5/1/2017	202,000	(9,000)	3.389	67% of LIBOR	Aa3, AA-, A+
Total	**$ 1,430,000**	**$ (44,000)**			

Basis Risk: The DWR is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR. The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while the DWR floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's cost would increase. As of June 30, 2005, the variable rate on DWR's bonds ranged from 2.1% to 2.5%, while 67% of LIBOR received on the swap was equal to 2.2%.

Termination Risk: The DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract or significantly loses creditworthiness. The DWR views the likelihood of either event to be remote at this time. If a termination were to occur, at the time of the termination DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. A termination would mean that DWR's underlying floating-rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk unless it entered into a new hedge.

Rollover Risk: Other than termination, there is no rollover risk associated with the swap agreements, because the agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt.

E. Discretely Presented Component Unit Variable Rate/Swap Disclosure – University of California

Table 32 includes debt service requirements and net swap payments as of June 30, 2005, of the University of California (UC), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $343 million, $85 million, and $50 million, respectively.

Objective: UC has entered into interest rate swap agreements as a means to lower borrowing costs, rather than using fixed-rate bonds at the time of issuance, and to effectively change the variable interest rate on bonds to a fixed rate of 3.1%. The swaps are with three financial institutions in connection with variable-rate refunding revenue bonds associated with the UC Davis Medical Center.

Terms: The bonds and related swap agreements mature on September 1, 2026. The aggregate notional amount of swaps matches the outstanding amounts on the bonds throughout the term of the bonds. UC pays the swap counterparties a fixed payment of 3.1% and receives a variable payment computed as 67% of the 30-day LIBOR. UC believes that, over time, the variable interest rates it pays on the bonds will approximate the variable payments it receives on the interest rate swaps, leaving the fixed interest rate payment on the swaps as the net payment obligation for the transaction.

Fair Value: The swaps have an estimated negative fair value of $5.5 million as of June 30, 2005, because interest rates have decreased since the execution of the swaps. The fair value is an indication of the difference in value of the swap fixed-interest payments due and the fixed-rate payments due on a swap with identical terms executed on June 30, 2005. The fair value of the interest rate swap is the estimated amount the UC would have paid if the swap agreement had been terminated on June 30, 2005. The fair value was estimated by the financial institutions using available quoted market prices or a forecast of expected discounted future cash flows.

Basis Risk: UC is exposed to basis risk whenever the interest rates on the bonds are reset. The interest rates on the bonds are tax-exempt interest rates reset weekly or daily, while the variable receipt rate on the interest rate swaps is taxable (67% of the 30-day LIBOR).

Termination and Interest Rate Risk: UC is exposed to losses in the event of nonperformance by counterparties or unfavorable interest rate movements. The swap may be terminated if the insurer's credit quality rating falls below A- as issued by Fitch Ratings or Standard & Poor's, thereby canceling the synthetic interest rate and returning the interest rate payments to the variable interest rates on the bonds. At termination, UC may also owe a termination payment if there is a realized loss on the fair value of the swap.

F. Discretely Presented Component Unit Variable Rate/Swap Disclosure – California Housing Finance Agency

Table 32 includes debt service requirements and net swap payments as of June 30, 2005, for the California Housing Finance Agency (CalHFA), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $4.5 billion, $1.3 billion, and $1.1 billion, respectively.

Objective: CalHFA has entered into interest rate swap agreements with various counterparties to protect itself against rising rates by providing a synthetic fixed rate for a like amount of variable-rate bond obligations. The majority of CalHFA's interest rate swap transactions are structured to pay a fixed rate of interest while receiving a variable rate of interest, with some exceptions. CalHFA previously entered into swaps at a ratio of 65% of LIBOR. Its current formula (60% of LIBOR plus a spread, currently .26%) results in comparable fixed-rate economics but performs better when short-term rates are low and the BMA/LIBOR percentage is high.

CaLHFA has used this new formula since December 2002, and it expects to continue to use this formula for LIBOR-based swaps exclusively. In addition, CalHFA entered into 13 basis swaps as a means to change the variable-rate formula received from counterparties for $667 million outstanding notional amount from 65% of LIBOR to varying floating rates.

Terms, Fair Value, and Credit Risk: Most of CalHFA's notional amounts of the swaps match the principal amounts of the associated debt. CalHFA has created a synthetic fixed rate by swapping a portion of its variable rate debt. CalHFA did not pay or receive any cash when the swap transactions were initiated. CalHFA utilizes ten counterparties for its interest rate swap transactions. Counterparties are required to collateralize their exposure to CalHFA when their credit ratings fall from AA to the highest single-A category, A1/A+. CalHFA is not required to provide collateralization until its ratings fall to the mid-single-A category, A2/A. CalHFA's swap portfolio has an aggregate negative fair value, due to a decline in interest rates, of $304 million as of June 30, 2005. Fair values are as reported by CalHFA's counterparties and are estimated using the zero-coupon method. As CalHFA's swap portfolio has an aggregate negative fair value, CalHFA is not exposed to credit risk. However, if interest rates rise, the negative fair value of the swap portfolio would be reduced and could eventually become positive. At that point, CalHFA would become exposed to the counterparties' credit because the counterparties would be obligated to make payments to CalHFA in the event of termination. CalHFA has 117 swap transactions, with outstanding notional amounts of $4.6 billion. Standard & Poor's credit ratings for these counterparties range from A+ to AAA; Moody's credit ratings range from Aa3 to Aaa.

Basis Risk: CalHFA's swaps contain the risk that the floating-rate component of the swap will not match the floating rate of the underlying bonds. This risk arises because floating rates paid by swap counterparties are based on indices that consist of market-wide averages, while interest paid on CalHFA's variable-rate bonds is specific to individual issues. CalHFA's variable-rate tax-exempt bonds trade at a slight discount to the BMA index. Swaps associated with tax-exempt bonds, for which CalHFA receives a variable-rate payment, are based on a percentage of LIBOR; thus, CalHFA is exposed to basis risk if the relationship between BMA and LIBOR converges. As of June 30, 2005, the BMA rate was 2.28%, 65% of the one-month LIBOR was 2.17%, and 60% of the one-month LIBOR plus 26 basis points was 2.26%.

Termination Risk: Counterparties to CalHFA's interest rate swaps have termination rights that require settlement payments by either CalHFA or the counterparties, based on the fair value of the swap. As of June 30, 2005, termination events occurred which required CalHFA to make settlement payments totaling $602,000.

Rollover Risk: CalHFA's swap agreements have limited rollover risk because the agreements contain scheduled reductions to outstanding notional amounts that are expected to follow scheduled and anticipated reductions in the associated bonds payable.

G. Revenue Bond Defeasances

1. Current Year

In January 2005, the primary government issued $272 million in Central Valley Project Water System Revenue Bonds, of which a portion of the proceeds were used to refund $251 million in outstanding bonds. The advance refunding resulted in the recognition of an accounting loss of approximately $18 million for fiscal year 2005. The primary government used the issuance of the Series AC bonds to provide debt service savings of more than $18 million over the next 23 years, with a net present value of $12 million.

In June 2004 and November 2004, CalHFA, a discretely presented component unit, issued Multifamily Housing Revenue Bonds, of which a portion of the proceeds were used to refund outstanding bonds. The loss from the debt refunding was deferred and will be amortized as a component of interest expense over the shorter of the term of bonds extinguished or the term of the refunding bonds. The refunding will decrease the debt service cash outflow for Multifamily Programs by approximately $15 million. The refunding may also provide for an economic gain for the Multifamily Programs, which is estimated to be approximately $10 million.

2. Prior Years

In prior years, the primary government defeased certain bonds by placing the proceeds of new bonds in irrevocable trust accounts to provide for all future debt service requirements. Accordingly, the assets and liabilities for these defeased bonds are not included in the financial statements. As of June 30, 2005, the outstanding balance of revenue bonds defeased in prior years was approximately $567 million.

In prior years, the University of California, a discretely presented component unit, defeased certain bonds. Investments that have maturities and interest rates sufficient to fund retirement of defeased liabilities are being held in irrevocable trusts for the debt service payments. Accordingly, the assets of the trust accounts and the liabilities for the defeased bonds are not included in the State's financial statements. As of June 30, 2005, the outstanding balance of University of California revenue bonds defeased in prior years was $306 million.

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NOTE 17: INTERFUND BALANCES AND TRANSFERS

A. Interfund Balances

Due from other funds and due to other funds represent short-term interfund receivables and payables resulting from the time lag between the dates that goods and services are provided and received and the dates that payments between entities are made. Table 34 presents the amounts due from and due to other funds.

Table 34

Schedule of Due From Other Funds and Due To Other Funds
June 30, 2005
(amounts in thousands)

	Due To					
Due From	**General Fund**	**Federal Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**	**Electric Power Fund**	**Water Resources Fund**
Governmental funds						
General Fund	$ —	$ —	$ 73,587	$ 1,325,374	$ —	$ —
Federal Fund	453,297	—	1,016,619	427,810	—	—
Transportation Construction Fund	—	—	—	27,101	—	—
Nonmajor governmental funds	104,973	—	7,202	281,009	—	—
Total governmental funds	**558,270**	**—**	**1,097,408**	**2,061,294**	**—**	**—**
Enterprise funds						
Water Resources Fund	—	—	—	—	—	—
Public Building Construction Fund	18,113	—	—	—	—	—
State Lottery Fund	228	—	—	279,531	—	—
Unemployment Programs Fund	132,129	—	—	70,695	—	—
Nonmajor enterprise funds	54,378	—	12,466	231	—	—
Total enterprise funds	**204,848**	**—**	**12,466**	**350,457**	**—**	**—**
Internal service funds	**1,102**	**85**	**19,601**	**109,655**	**26,000**	**3,060**
Fiduciary funds	**746**	**—**	**—**	**61**	**—**	**—**
Total primary government	**$ 764,966**	**$ 85**	**$ 1,129,475**	**$ 2,521,467**	**$ 26,000**	**$ 3,060**

Due To						
Public Building Construction Fund	State Lottery Fund	Unemployment Programs Fund	Nonmajor Enterprise Funds	Internal Service Funds	Fiduciary Funds	Total
$ —	$ 3,675	$ —	$ —	$ 103,090	$ 3,749,496	$ 5,255,222
—	—	2,459	—	57,750	2,904,140	4,862,075
—	—	—	—	9,348	—	36,449
249	—	—	48	21,371	121,049	535,901
249	**3,675**	**2,459**	**48**	**191,559**	**6,774,685**	**10,689,647**
—	—	—	—	50,639	—	50,639
—	—	—	—	9,181	6,129	33,423
—	—	—	—	—	—	279,759
—	—	—	—	—	—	202,824
—	—	—	—	45	—	67,120
—	**—**	**—**	**—**	**59,865**	**6,129**	**633,765**
17,290	**—**	**17,740**	**8,343**	**54,022**	**13,262**	**270,160**
—	**—**	**—**	**—**	**1,657**	**241**	**2,705**
$ 17,539	**$ 3,675**	**$ 20,199**	**$ 8,391**	**$ 307,103**	**$ 6,794,317**	**$ 11,596,277**

Interfund receivables and payables are the result of interfund loans that are not expected to be repaid within one year. The $2.3 billion in nonmajor governmental funds payable from the General Fund is primarily the result of legislation authorizing the transfer of cash from special revenue funds to the General Fund. Table 35 presents the interfund receivables and payables.

Table 35

Schedule of Interfund Receivables and Payables
June 30, 2005
(amounts in thousands)

	Interfund Payables						
Interfund Receivables	**General Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**	**Water Resources Fund**	**Nonmajor Enterprise Funds**	**Fiduciary Funds**	**Total**
Governmental funds							
General Fund	$ —	$ —	$ 2,261,411	$ —	$ 7,100	$ 1,011,800	$ 3,280,311
Nonmajor governmental funds	13,849	628,900	—	—	—	—	642,749
Total governmental funds	**13,849**	**628,900**	**2,261,411**	**—**	**7,100**	**1,011,800**	**3,923,060**
Enterprise funds	**829**	**—**	**—**	**—**	**2,300**	**—**	**3,129**
Internal service funds	**3,000**	**—**	**2,257**	**91,517**	**—**	**—**	**96,774**
Fiduciary funds	**134,301**	**—**	**—**	**—**	**—**	**—**	**134,301**
Total primary government	**$ 151,979**	**$ 628,900**	**$ 2,263,668**	**$ 91,517**	**$ 9,400**	**$ 1,011,800**	**$ 4,157,264**

Due from primary government and due to component units represent short-term receivables and payables between the primary government and component units resulting from the time lag between the dates that goods and services are provided and received and the dates that payments between entities are made. Table 36 presents the due from primary government and due to component units.

Table 36

Schedule of Due From Primary Government and Due To Component Units
June 30, 2005
(amounts in thousands)

	Due To			
Due From	**University of California**	**Public Employees' Benefits**	**Nonmajor Component Units**	**Total**
Governmental funds				
General Fund	$ 140,257	$ 17	$ —	$ 140,274
Nonmajor governmental funds	30,322	—	—	30,322
Total governmental funds	**170,579**	**17**	**—**	**170,596**
Public Building Construction Fund	**25,653**	**—**	**—**	**25,653**
Internal service funds	**—**	**3,610**	**1,174**	**4,784**
Total primary government	**$ 196,232**	**$ 3,627**	**$ 1,174**	**$ 201,033**

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B. Interfund Transfers

As required by law, transfers move money collected by one fund to another fund, which disburses it. The General Fund and certain other funds transfer money to support various programs accounted for in other funds. The largest transfers from the General Fund to the nonmajor governmental funds were $1.3 billion for the support of trial courts and $1.2 billion to the Local Revenue Fund to repay the vehicle license fee gap loan to local governments. The $918 million transfer from the Federal Fund to the nonmajor governmental funds was primarily for the administration of the unemployment programs. The largest transfers from the nonmajor governmental funds to the General Fund were $140 million from the Traffic Congestion Relief Fund and $86 million from the Workers' Compensation Administration Revolving Fund to support General Fund programs. Table 37 presents interfund transfers of the primary government.

Table 37

Schedule of Interfund Transfers
June 30, 2005
(amounts in thousands)

	Transferred To		
Transferred From	**General Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**
Governmental funds			
General Fund	$ —	$ —	$ 3,002,509
Federal Fund	—	—	917,849
Transportation Construction Fund	19,222	—	33,282
Nonmajor governmental funds	350,917	2,590	199,651
Total governmental funds	**370,139**	**2,590**	**4,153,291**
Enterprise funds			
Nonmajor enterprise funds	32,952	6,886	3,437
Total enterprise funds	**32,952**	**6,886**	**3,437**
Internal service funds	**3,500**	**1,152**	**6,254**
Total primary government	**$ 406,591**	**$ 10,628**	**$ 4,162,982**

Transferred To				
Unemployment Programs Fund	Public Building Construction Fund	Nonmajor Enterprise Funds	Fiduciary Funds	Total
$ —	$ —	$ 96	$ 4,229	$ 3,006,834
12,141	—	—	—	929,990
—	—	—	—	52,504
—	—	3,272	1,034	557,464
12,141	**—**	**3,368**	**5,263**	**4,546,792**
—	462	40	**—**	43,777
—	**462**	**40**	**—**	**43,777**
39	**—**	**—**	**—**	**10,945**
$ 12,180	**$ 462**	**$ 3,408**	**$ 5,263**	**$ 4,601,514**

NOTE 18: FUND DEFICITS AND ENDOWMENTS

A. Fund Deficits

Table 38 shows the funds that had deficits.

Table 38

Schedule of Fund Deficits
June 30, 2005
(amounts in thousands)

	Governmental Funds	Internal Service Funds	Component Units
Higher Education Construction Fund	$ 315,617	$ —	$ —
Other capital projects funds	8,107	—	—
Architecture Revolving Fund	—	14,314	—
Water Resources Revolving Fund	—	3,414	—
Public Employees' Benefits Fund	—	—	518,624
California Consumer Power and Conservation Financing Authority Fund	—	—	4,259
Total	**$ 323,724**	**$ 17,728**	**$ 522,883**

B. Discretely Presented Component Unit Endowments and Gifts

The University of California, a discretely presented component unit, administers certain restricted nonexpendable, restricted expendable, and unrestricted endowments that are included in the related net asset categories of the government-wide and fund financial statements. As of June 30, 2005, the total value of restricted and unrestricted endowments and gifts was $7.9 billion and $1.1 billion, respectively. The university's policy is to retain appreciation on investments with the endowment after an annual income distribution. Endowment income capitalized to endowment principal that is available to meet future funding needs upon approval by the board of regents amounted to $1.4 billion at June 30, 2005. The portion of investment returns earned on endowments and distributed each year to support current operations is based on a rate approved by the board of regents.

NOTE 19: RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. Generally, the exceptions are when a bond resolution or a contract requires the primary government to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, there has been no insurance settlement in the last three years that has exceeded insurance coverage. The primary government generally does not maintain reserves. Losses are covered by appropriations from each fund responsible for payment in the year in which the payment occurs. All claim payments are on a "pay as you go" basis, with workers' compensation benefits for self-insured agencies being initially paid by the State Compensation Insurance Fund. The potential amount of loss arising from risks other than workers' compensation benefits is not considered material in relation to the primary government's financial position.

The discounted liability for unpaid self-insured workers' compensation losses is estimated to be $2.8 billion as of June 30, 2005. This estimate is based on actuarial reviews of the State's employee workers' compensation program and includes indemnity payments to claimants, as well as all other costs of providing workers' compensation benefits, such as medical care and rehabilitation. The estimate also includes the liability for unpaid services fees, industrial disability leave benefits, and incurred but not reported amounts. The estimated total liability of approximately $3.9 billion is discounted to $2.8 billion using a 4% interest rate. Of the total, $341 million is a current liability, of which $208 million is included in the General Fund, $132 million in the special revenue funds, and $1 million in the internal service funds. The remaining $2.5 billion is reported as other noncurrent liabilities in the government-wide Statement of Net Assets.

The University of California, a discretely presented component unit, is self-insured for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based upon an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 4.0% to 6.0%. The other discretely presented component units do not have significant liabilities related to self-insurance.

Changes in the self-insurance claims liability for the primary government and the University of California are shown in Table 39.

Table 39

Schedule of Changes in Self-Insurance Claims
Years Ended June 30
(amounts in thousands)

	Primary Government		University of California – Discretely Presented Component Unit	
	2005	**2004**	**2005**	**2004**
Unpaid claims, beginning	$ 2,724,835	$ 2,828,010	$ 566,962	$ 520,177
Incurred claims	455,108	298,978	250,264	289,247
Claim payments	(372,225)	(402,153)	(255,399)	(242,462)
Unpaid claims, ending	**$ 2,807,718**	**$ 2,724,835**	**$ 561,827**	**$ 566,962**

NOTE 20: NONMAJOR ENTERPRISE SEGMENT INFORMATION

A segment is an identifiable activity reported as or within an enterprise fund or another stand-alone entity for which debt is outstanding and a revenue stream has been pledged in support of that debt. In addition, to qualify as a segment, an activity must be subject to an external requirement to separately account for revenues, expenses, gains and losses, assets, and liabilities of the activity. All of the activities reported in the following condensed financial information meet these requirements.

Table 40 presents the Condensed Statement of Net Assets, the Condensed Statement of Revenues, Expenses, and Changes in Fund Net Assets, and the Condensed Statement of Cash Flows for nonmajor enterprise funds that meet the definition of a segment. The primary sources of revenues for these funds follow.

High Technology Education Fund: Rental payments on public buildings which are used for educational and research purposes related to specific fields of high technology.

State University Dormitory Building Maintenance and Equipment Fund: Charges to students for housing and parking, and student fees for campus unions.

State Water Pollution Control Revolving Fund: Interest charged on loans to communities for construction of water pollution control facilities and projects.

Housing Loan Fund: Interest payments from low interest, long-term farm and home mortgage loan contracts to eligible veterans living in California.

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Table 40

Nonmajor Enterprise Segments

(amounts in thousands)

Condensed Statement of Net Assets

June 30, 2005

	High Technology Education	State University Dormitory Building Maintenance and Equipment
Assets		
Due from other funds	$ 400	$ —
Due from other governments	—	—
Other current assets	31,366	743,219
Capital assets	—	1,610,128
Other noncurrent assets	433,819	14,520
Total assets	**$ 465,585**	**$ 2,367,867**
Liabilities		
Due to other funds	$ —	$ 27,834
Due to other governments	—	—
Other current liabilities	34,782	108,906
Noncurrent liabilities	304,192	1,683,858
Total liabilities	**338,974**	**1,820,598**
Net assets		
Investment in capital assets, net of related debt	—	—
Restricted	126,611	389,887
Unrestricted	—	157,382
Total net assets	**126,611**	**547,269**
Total liabilities and net assets	**$ 465,585**	**$ 2,367,867**

Condensed Statement of Revenues, Expenses, and Changes in Fund Net Assets

Year Ended June 30, 2005

Operating revenues	$ 36,737	$ 378,670
Depreciation expense	—	(62,842)
Other operating expenses	(33,690)	(357,878)
Operating income (loss)	3,047	(42,050)
Nonoperating revenues (expenses)	—	(11,634)
Capital contributions	—	—
Transfers in	96	—
Transfers out	(462)	(2,484)
Change in net assets	2,681	(56,168)
Total net assets, July 1, 2004	**123,930**	**603,437** *
Total net assets, June 30, 2005	**$ 126,611**	**$ 547,269**

Condensed Statement of Cash Flows

Year Ended June 30, 2005

Net cash provided (used) by:		
Operating activities	$ 37,571	$ (30,518)
Noncapital financing activities	(358)	(30,844)
Capital and related financing activities	(37,060)	166,033
Investing activities	—	16,726
Net increase (decrease)	**153**	**121,397**
Cash and pooled investments at July 1, 2004	**50,839**	**577,832**
Cash and pooled investments at June 30, 2005	**$ 50,992**	**$ 699,229**

* Restated

State Water Pollution Control	Housing Loan	Total
$ 2,215	$ 3,615	$ 6,230
148,082	—	148,082
318,430	596,114	1,689,129
—	2,498	1,612,626
2,016,992	1,613,948	4,079,279
$ 2,485,719	**$ 2,216,175**	**$ 7,535,346**
$ 873	$ 22	$ 28,729
—	242	242
26,540	110,404	280,632
264,752	1,862,321	4,115,123
292,165	**1,972,989**	**4,424,726**
—	2,497	2,497
746,497	240,689	1,503,684
1,447,057	—	1,604,439
2,193,554	**243,186**	**3,110,620**
$ 2,485,719	**$ 2,216,175**	**$ 7,535,346**
$ 47,907	$ 119,029	$ 582,343
—	(900)	(63,742)
(4,082)	(140,977)	(536,627)
43,825	(22,848)	(18,026)
(3,245)	1,826	(13,053)
73,182	—	73,182
—	—	96
—	—	(2,946)
113,762	(21,022)	39,253
2,079,792	**264,208**	**3,071,367**
$ 2,193,554	**$ 243,186**	**$ 3,110,620**
$ (56,553)	$ 29,952	$ (19,548)
38,618	(125,223)	(117,807)
—	—	128,973
6,296	46,259	69,281
(11,639)	**(49,012)**	**60,899**
329,962	**610,145**	**1,568,778**
$ 318,323	**$ 561,133**	**$ 1,629,677**

NOTE 21: NO COMMITMENT DEBT

Certain debt of the nonmajor component units is issued to finance activities such as construction of new facilities and remodeling of existing facilities, and acquisition of equipment. This debt is secured solely by the credit of private and public entities and is administered by trustees independent of the State. As of June 30, 2005, these component units had $17.2 billion of debt outstanding, which is not debt of the State.

The State has also entered into transactions that involve debt issued by four special purpose trusts that were created by one of its nonmajor component units, the California Infrastructure and Economic Development Bank. The special purpose trusts are legally separate entities that issued long-term debt for the primary purpose of financing certain costs of assets and obligations that are recoverable by utilities through electric rate charges. These costs may prevent the utilities from offering electricity at lower rates in a competitive market. As of June 30, 2005, the special purpose trusts had approximately $1.5 billion of debt outstanding. Like the debt of nonmajor component units, the debt of the special purpose trusts is not debt of the State.

NOTE 22: CONTINGENT LIABILITIES

A. Litigation

The primary government is a party to numerous legal proceedings, many of which normally occur in governmental operations. To the extent they existed, the following were accrued as a liability in the government-wide financial statements: legal proceedings that were decided against the primary government before June 30, 2005; legal proceedings that were in progress as of June 30, 2005, and were settled or decided against the primary government as of February 28, 2006; and legal proceedings having a high probability of resulting in a decision against the primary government as of February 28, 2006, and for which amounts could be estimated. In the governmental fund financial statements, 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. In the proprietary fund financial statements, the entire liability is recorded in the fund from which payment will be made.

In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may impair its revenue sources or require it to make significant expenditures. Because of the prospective nature of these proceedings, no provision for the potential liability has been made in the financial statements.

Following are the more significant lawsuits pending against the primary government.

The primary government was a defendant in *County of San Diego v. Commission on State Mandates et al.,* regarding certain unreimbursed costs for the care of medically indigent adults (MIAs). In 1997, the California Supreme Court ruled that, by excluding MIAs from Medi-Cal, the State had mandated a new program on the counties. San Diego County prevailed, and the State paid the County $3 million for unreimbursed costs related to the mandated services. The commission has taken the position that it would be bound to apply the holding of the San Diego County case to any new claim for prospective relief brought by any county as a “test claim.” A test claim filed by the County of San Bernardino (county) regarding certain unreimbursed costs for the care of MIAs is now pending before the commission. In recent years, counties have collectively received approximately $1.0 billion annually in vehicle license fee revenue and $410 million annually in sales tax revenue to fund various public health programs, which include programs that provide services to MIAs; however, the county

claims that funding is inadequate to cover all services to MIAs mandated by the State. The county's test claim poses a potential for a negative impact on the General Fund in the amount of the unreimbursed costs for all similarly situated county claimants for a period of years, as determined by the commission. The amount demanded by the county for the 2000-01 fiscal year alone is over $9 million. Certain estimates of the annual cost of services rendered by all counties to MIAs exceed $4.0 billion. It is difficult to determine how much could be recovered by the counties, because each situation is fact-driven and lack of documentation was a major concern in the San Diego case.

The primary government is a party in several lawsuits which allege that the gross receipts from the plaintiffs' sale of certain short-term financial instruments constitute business income and therefore must be included in the denominator of the California sales factor of the apportionment formula to be applied to the business income of the plaintiffs. The plaintiffs further contend that the exclusion is a violation of their rights under the due process and commerce clauses of the U.S. Constitution. The Franchise Tax Board (board) maintains that, under pertinent tax statutes, the return of the original loan proceeds from a maturing debt instrument is not a "gross receipt" for sales factor purposes and thus must be excluded from the denominator of the sales factor. The board estimates that the amount at issue to all taxpayers for prior years could exceed $500 million. The lead case in this issue is currently waiting the California Supreme Court to set the case for oral argument. The other five cases are on hold and are pending the lead case decision. In addition, one taxpayer is claiming that the board improperly excluded value-added taxes from the denominator of the sales factor and should have valued property for purposes of the property factor of the apportionment formula at current fair market value rather than historical cost.

The primary government is a defendant in a lawsuit alleging the petitioners, Medi-Cal beneficiaries, seek direct reimbursement from the Department of Health Services for covered expenses they paid out-of-pocket while petitioners applications for benefits were pending. The Department may be liable for more than $800 million in out-of-pocket payments. The Department is working with petitioners' counsel to address the directive of the First District Court of Appeal as to the creation of an acceptable implementation plan and notice to beneficiaries regarding reimbursement procedures for the out-of-pocket payments. A hearing on the proposed plan is set for January 2006.

The primary government was a defendant in an action, *Sanchez, et al., v. Johnson, et al.,* where a class of persons with developmental disabilities is seeking injunctive relief against the Health and Human Services Agency and the departments of Developmental Services, Mental Health, and Finance, to obtain higher funding rates for service providers. The State received favorable rulings from the Ninth District Court of Appeals. The Plaintiff has declined to seek review by the U.S. Supreme Court.

The primary government is a party to the lawsuit of *Alan J. Titus and Marjorie Goldman v. County of Marin,* an action related to property taxation. Propositions 13 and 8 limit property tax to 1% of a property's base year value, which is essentially the acquisition value. This base year value can be increased by not more than 2% per annum but may be reduced by any amount to reflect loss of value. The plaintiffs contend that the common assessor practice whereby value is brought back up after a temporary reduction without regard to the 2% limitation is unconstitutional. The trial court ruled against taxpayers Titus and Goldman, who appealed. The State received favorable rulings through the U.S. Supreme Court, which denied plaintiffs petition for review.

The University of California (UC), the State Compensation Insurance Fund (SCIF), the California Housing Finance Agency (CalHFA), the Public Employees' Benefits Fund (PEBF), and nonmajor discretely presented component units are contingently liable in connection with claims and contracts, including those currently in litigation, arising in the normal course of their activities. Although there are inherent uncertainties in any litigation, the management and the general counsel of UC, SCIF, CalHFA, and PEBF are of the opinion that the

outcome of such matters either is not expected to have a material effect on the financial statements or cannot be estimated at this time.

B. Federal Audit Exceptions

The primary government receives substantial funding from the federal government in the form of grants and other federal assistance. The primary government, UC, and CalHFA are entitled to these resources only if they comply with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; they may spend these resources only for eligible purposes. If audits disclose exceptions, the primary government, UC, and CalHFA may incur a liability to the federal government.

NOTE 23: PENSION TRUSTS

Three retirement systems, the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the University of California Retirement System, all of which are fiduciary component units, are included in the pension and other employee benefit trust funds column of the fiduciary funds and similar component units' financial statements. The pension liability for all pension and other employee benefit trust funds was determined in accordance with GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*. The amounts of the pension liability for all pension and other employee benefit trust funds are presented in Table 42 as the net pension obligation (NPO) as of June 30, 2005. The investments of these fiduciary component units are presented in Table 6 in Note 3, Deposits and Investments.

CalPERS administers five defined benefit retirement plans: the Public Employees' Retirement Fund (PERF), the Judges' Retirement Fund (JRF), the Judges' Retirement Fund II (JRF II), the Legislators' Retirement Fund (LRF), and the Volunteer Firefighters' Length of Service Award Fund (VFF). CalPERS also administers three defined contribution plans: the State Peace Officers' and Firefighters' Defined Contribution Plan Fund (SPOFF), the public employee Replacement Benefit Fund (RBF), and the public employee Supplemental Contributions Program Fund (SCPF). CalPERS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229 or by visiting the CalPERS website at www.CalPERS.ca.gov.

CalPERS uses the accrual basis of accounting. Member contributions are recognized when due. The VFF, the SPOFF, and the RBF are funded only by employer contributions that are recorded when due, and the employer has made a formal commitment to provide the contributions. Benefits under the defined benefit plans and refunds are recognized when due, in accordance with the terms of each plan.

CalSTRS administers three defined benefit retirement plans within the State Teachers' Retirement Plan: the Defined Benefit Program (DB Program), the Defined Benefit Supplement Program, and the Cash Balance Benefit Program. CalSTRS also offers, through a third-party administrator, a defined contribution plan that meets the requirements of Internal Revenue Code Section 403(b). The Teachers' Health Benefits Fund provides post-employment health benefits to retired members of the DB Program. CalSTRS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851.

CalSTRS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are due. Employer and primary government contributions are recognized when due, and the

employer or the primary government has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable, in accordance with the retirement and benefits programs.

A. Public Employees' Retirement Fund

1. Fund Information

Plan Description: CalPERS administers the PERF, which is an agent multiple-employer defined benefit retirement plan. Employers participating in the PERF include the primary government and certain discretely presented component units, 61 school employers, and 1,462 public agencies as of June 30, 2005. For reporting purposes, the financial information of the RBF is combined with that of the PERF.

The amount by which the actuarial accrued liability exceeded the actuarial value of assets in the PERF for the primary government and other participating agencies was $24.7 billion at June 30, 2004. This is a result of the difference between the actuarial value of assets of $169.9 billion and the actuarial accrued liability of $194.6 billion. Contributions are actuarially determined.

2. Employer's Information

Plan Description: The primary government and certain discretely presented component units contribute to the PERF. CalPERS acts as a common investment and administrative agent of the primary government and the other member agencies. The discretely presented component units' participation in the PERF is not a material portion of the program. The primary government employees served by the PERF include: first-tier and second-tier miscellaneous and industrial, California Highway Patrol, peace officers and firefighters, and other safety members. The payroll for primary government employees covered by the PERF in the year ended June 30, 2005, was approximately $12.9 billion.

All employees in a covered class of employment who work half-time or more are eligible to participate in the PERF. The PERF provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years, or after ten years for second-tier employees. The PERF provides death, disability, and survivor benefits. The benefit provisions are established by statute.

Funding Policy: Benefits are funded by contributions from members and the primary government and earnings from investments. Member and primary government contributions are a percentage of applicable member compensation. Member rates are defined by law and based on the primary government's benefit formula. The primary government contribution rates are determined by periodic actuarial valuations.

Employees, with the exception of employees in the second-tier plans, contribute to the fund based on the required contribution rates. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $133 to $863. Employees' required contributions vary from 5.0% to 8.0% of their salary over the base compensation amount.

All of the primary government employees served by the PERF are now covered by group term life insurance. The required employer contribution rates for the primary government are shown in Table 41.

Table 41

Schedule of Required Employer Contribution Rates for the Primary Government by Member Category

Year Ended June 30, 2005

	Normal Cost	Unfunded Liability	Group Term Life Benefit	Total Rate
Miscellaneous members				
First tier	9.928 %	6.982 %	0.112 %	17.022 %
Second tier	6.122	6.982	0.112	13.216
Industrial (first and second tier)	12.765	3.530	0.091	16.386
California Highway Patrol	15.307	18.127	0.000	33.434
Peace officers and firefighters	17.276	6.487	0.078	23.841
Other safety members	15.028	5.607	0.138	20.773

For the year ended June 30, 2005, the annual pension cost (APC) and the amount of contributions made by the primary government were each $2.5 billion. The APC and the percentage of APC contributed for the last three years are shown in Table 42. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 2004, is also shown in Table 42 for the primary government.

B. Judges' Retirement Fund

Plan Description: CalPERS administers the JRF, which is an agent multiple-employer defined benefit retirement plan. The JRF membership includes justices of the Supreme Court and courts of appeal, as well as judges of superior courts, appointed or elected prior to November 9, 1994. There are 59 employers participating in the JRF for the year ended June 30, 2005. The payroll for employees covered by the JRF for the year ended June 30, 2005, was approximately $134 million. The primary government pays the employer contributions for all employees covered by the JRF.

The JRF provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF provides death, disability, and survivor benefits. Benefits for the JRF are established by the Judges' Retirement Law.

Funding Policy: The contribution rate of active plan members is defined by law and is based on a percentage of salary over a base compensation amount. For the year ended June 30, 2005, the required member rate for the JRF was 8.0%.

The contributions of the primary government to the JRF are not actuarially determined. Contributions are determined by state statute. As of June 30, 2005, employer contributions are required to be 8.0% of applicable member compensation. Other funding to meet benefit payment requirements of the JRF is currently provided by: filing fees, which require varying amounts, depending on fee rate and number of filings; investments, which earn the current yield on short-term investments; and the primary government's balancing contributions, as required by the Judges' Retirement Law. The balancing contributions are an amount at least equal to the

estimated benefits payable during the ensuing fiscal year, less the sum of the estimated member contributions during the ensuing fiscal year and net assets available for benefits at the beginning of the fiscal year ("pay as you go" basis).

The annual pension cost (APC) and the amount of employer contributions made to the JRF for the year ended June 30, 2005, were $184 million and $127 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 2005, was $1.13 billion, an increase of $57 million over last year's balance of $1.07 billion. The APC is comprised of $190 million for the annual required contribution (ARC), $75 million for interest on the NPO, and $81 million for the adjustment to the ARC. An actuarial valuation of the JRF's assets and liabilities is made annually. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 42. Information on the last valuation, which was performed as of June 30, 2004, is shown in Table 42. The aggregate cost method that was used for the June 30, 2004, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 42.

C. Judges' Retirement Fund II

Plan Description: CalPERS administers the JRF II, which is an agent multiple-employer defined benefit retirement plan. The membership of the JRF II includes justices of the same courts covered by the JRF who were appointed or elected on or subsequent to November 9, 1994. There are 59 employers participating in the JRF II. The payroll for employees covered by the JRF II for the year ended June 30, 2005, was approximately $105 million. The primary government pays the employer contributions for all employees covered by the JRF II.

The JRF II provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF II provides death, disability, and survivor benefits. Benefits for the JRF II are established by the Judges' Retirement System II Law.

Funding Policy: The required contribution rate of active plan members is defined by law and is based on a percentage of salary over a base compensation amount. For the year ended June 30, 2005, the required member rate for the JRF II was 8.0%, and the primary government's contribution rate for the JRF II was 20.25% of applicable member compensation.

Actuarial valuations for the JRF II are required to be carried out annually. The legislated primary government contribution rate is adjusted periodically as part of the annual Budget Act, in order to maintain or restore the actuarial soundness of the fund.

For the year ended June 30, 2005, the annual pension cost (APC) and the amount of contributions made for the JRF II were approximately $21 million. The APC and the percentage of APC contributed for the year ended June 30, 2005, are shown in Table 42. Information on the last valuation, which was performed as of June 30, 2004, is also shown in Table 42.

D. Legislators' Retirement Fund

Plan Description: CalPERS administers the LRF, which is a single-employer defined benefit retirement plan. The eligible membership of the LRF includes state legislators serving in the legislature prior to November 1, 1990, constitutional officers, and legislative statutory officers. The payroll for the employees covered by the LRF for the year ended June 30, 2005, was approximately $1.7 million.

The LRF provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The plan provides death, disability, and survivor benefits. Benefits for the LRF are established by the Legislators' Retirement Law.

The LRF is currently in transition. The number of legislators eligible to participate in the LRF is declining as incumbent legislators leave office and are replaced by new legislators who are not eligible to participate in the program. Eventually, the only active members in the LRF will be approximately 16 constitutional officers (including the Insurance Commissioner and members of the Board of Equalization) and approximately four legislative statutory officers.

Funding Policy: The employer contribution requirements of the LRF are based on actuarially determined rates. An actuarial valuation of the LRF's assets and liabilities is required at least every two years. Member contribution rates are defined by law. For the year ended June 30, 2005, contributions made by employees were not required because the plan was superfunded. By definition, "superfunded" is when the plan's actuarial value of assets exceeds the present value of future benefits for current members. However, some members made contributions towards military service and prior service.

The net pension obligation (NPO) of the LRF on June 30, 2005, was approximately $10 million. There was no annual pension cost (APC) because the annual required contribution (ARC) equaled zero and the interest on the NPO closely approximated the adjustment to the ARC. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 42. An actuarial valuation of the LRF's assets and liabilities is made annually. Information on the last valuation, which was performed as of June 30, 2004, is also shown in Table 42. The aggregate cost method that was used for the June 30, 2004, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 42.

E. Volunteer Firefighters' Length of Service Award Fund

Plan Description: CalPERS administers the VFF, which is an agent multiple-employer defined benefit retirement plan. The VFF membership includes volunteer firefighters. There were 61 fire departments participating in the VFF for the year ended June 30, 2005.

The actuarial accrued liability of the VFF exceeded the actuarial value of assets by $550,000 at June 30, 2004. This is a result of the difference between the actuarial accrued liability of $3.5 million and the actuarial value of assets of $3.0 million. Contributions are actuarially determined.

F. State Peace Officers' and Firefighters' Defined Contribution Plan Fund

Plan Description: CalPERS administers the SPOFF, which is a defined contribution pension plan. The plan is a qualified money purchase pension plan under Section 401(a) of Title 26 of the Internal Revenue Code, and it is intended to supplement the retirement benefits provided by the Public Employees' Retirement Fund to eligible correctional employees employed by the State of California.

Funding Policy: Contributions to the plan are funded entirely by the primary government with a contribution rate of 2% of the employee's base pay, not to exceed contribution limits established by the Internal Revenue Code. Contribution requirements are established and may be amended through a memorandum of understanding from the State of California Department of Personnel Administration. These contributions, as well as the participant's share of the net earnings of the fund, are credited to the participant's account. For the

year ended June 30, 2005, contributions by the primary government to the SPOFF were approximately $41.4 million.

The net earnings of the fund are allocated to the participant's account as of each valuation date, in the ratio that the participant's account balance bears to the aggregate of all participants' account balances. The benefit paid to a participant will depend only on the amount contributed to the participant's account and earnings on the value of the participant's account. Plan provisions are established by and may be amended by statute. At June 30, 2005, there were 34,922 participants.

G. Teachers' Retirement Fund

Plan Description: CalSTRS administers the Teachers' Retirement Fund, which is an employee benefit trust fund created to administer the State Teachers' Retirement Plan (STRP). The STRP is a defined benefit pension plan that provides for retirement, disability, and survivor benefits. The STRP is comprised of three programs: the Defined Benefit (DB) Program, the Defined Benefit Supplement (DBS) Program, and the Cash Balance (CB) Benefit Program. The STRP is a cost-sharing, multiple-employer, defined benefit retirement plan that provides pension benefits to teachers and certain other employees of the California public school system.

Membership in the DB Program is mandatory for all employees meeting the eligibility requirements. The DB Program provides benefits based on a member's age, final compensation, and years of service. Vesting occurs after five years. In addition, the retirement program provides benefits to members upon disability and to survivors upon the death of eligible members. The Teachers' Retirement Law establishes the benefits for the DB Program. At June 30, 2005, the DB Program had approximately 1,300 contributing employers and as of June 30, 2004, had approximately 561,000 active and inactive program members, and 193,000 benefit recipients. The primary government is a nonemployer contributor to the DB Program. The payroll for employees covered by the DB Program for the year ended June 30, 2005, was approximately $23.9 billion.

Membership in the DBS Program is automatic for all members of the DB Program. The DBS Program provides benefits based on the balance of member accounts. Vesting occurs immediately. The Teachers' Retirement Law establishes the benefits for the DBS Program. The primary government does not contribute to the DBS Program.

The CB Program is designed for employees of California public schools who are hired to perform creditable service for less than 50% of the full-time equivalent for the position. Participation in the CB Program is optional to employers. However, if the employer elects to offer the CB Program, each eligible employee will automatically be covered by the CB Program unless the member elects to participate in the DB Program or an alternative plan provided by the employer within 60 days of hire. At June 30, 2005, the CB Program had 28 contributing school districts and approximately 21,000 contributing participants.

Funding Policy: DB Program benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Member and employer contributions are a percentage of applicable member earnings. The Teachers' Retirement Law governs member rates, employer contribution rates, and primary government contributions.

The DB Program contribution rate of members is 6% of creditable compensation through December 31, 2010, increasing to 8% thereafter for service less than or equal to one year of creditable service per fiscal year. The employer contribution rate is 8.25% of creditable compensation for service less than or equal to one year of creditable service per fiscal year; for service in excess of one year within one fiscal year, the employer

contribution rate is 0.25%. In fiscal year 2004-05, the General Fund contribution was 2.017% of total creditable compensation of the fiscal year ending in the prior calendar year. Education code 22955(b) states that the General Fund will contribute additional quarterly payments at a contribution rate of 0.524% of creditable earnings of the fiscal year ending in the immediately preceding calendar year when there is an unfunded obligation or a normal cost deficit. The percentage is adjusted up to 0.25% per year to reflect the contributions required to fund the unfunded obligation or the normal cost deficit. However, the transfer may not exceed 1.505% of creditable compensation from the immediately preceding calendar year. The normal cost deficit is the difference between the normal cost rate and the member and employer contributions, which equal 16.00% of creditable compensation. Based on the most recent actuarial valuation, as of June 30, 2004, there is no normal cost deficit or an unfunded obligation for benefits in place as of July 1, 1990. Therefore, the General Fund is not required to contribute quarterly payments starting October 1, 2005, at a contribution rate of 0.524%.

The DBS Program member contribution rate is 2% of creditable compensation for service less than or equal to one year of creditable service per fiscal year. For service in excess of one year within one fiscal year, the member contribution rate is 8% and the employer rate is 8%.

For the year ended June 30, 2005, the annual pension cost (APC) for the DB Program was approximately $3.8 billion, and the employer and primary government contributions were approximately $2.0 billion and $0.6 billion, respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 42. Actuarial valuations of the DB Program are performed biennially. Information from the last valuation is shown in Table 42.

H. CalSTRS Voluntary Investment Program

Plan Description: CalSTRS administers the Voluntary Investment Program (VIP), a 403(b) program, through a third-party administrator. The VIP is a defined contribution plan and is open to any employee who is eligible to participate. Contributions to the program are voluntary; however, the Internal Revenue Code does impose a maximum amount that can be contributed annually. At June 30, 2005, the VIP had 403 participating employers (school districts) and 3,519 plan members.

I. Teachers' Health Benefits Fund

Plan Description: CalSTRS administers the Teachers' Health Benefits Fund (THBF), which was established pursuant to Chapter 1032, Statutes of 2000 (SB 1435), to provide the Medicare Premium Payment Program for eligible retired members of the DB Program. At June 30, 2005, there were 6,004 benefit recipients.

Funding Policy: The THBF is funded as needed from the monthly DB Program statutory employer contribution that exceeds the amount needed to finance the liabilities of the DB Program based on the June 30, 2000, acturial valuation of the DB Program.

J. University of California Retirement System

The University of California Retirement System (UCRS) consists of: the University of California Retirement Plan (UCRP), a single-employer defined benefit plan funded with university and employee contributions; the Public Employees' Retirement System Voluntary Early Retirement Incentive Program (PERS-VERIP), a defined benefit plan for university employees who elected early retirement under the plan; and the University of California Retirement Savings Program that includes three defined contribution plans with options to

participate in internally and externally managed investment porfolios funded with employee non-elective and elective contributions. Most university career employees participate in the UCRS.

The UCRS uses the accrual basis of accounting. As of June 30, 2005, employee and employer contributions were not required to UCRP and PERS-VERIP, due to the fully funded status of each plan. Any contributions made in connection with service credit buybacks are recognized in the period in which they are made. Benefits and refunds are recognized when due and payable, in accordance with the terms of each plan.

The UCRP provides lifetime retirement income, disability protection, death benefits, and pre-retirement survivor benefits to eligible employees of the University of California and its affiliates. Membership in the retirement plan is required for all employees appointed to work at least 50% time for a year or more. Generally, an employee must have five years of service to be entitled to plan benefits. The maximum monthly benefit is 100% of the employee's highest average compensation over a 36-month period. The amount of the pension benefit is determined by salary rate, age, and years of service credit, with certain cost-of-living adjustments.

Members' contributions to the UCRP are accounted for separately and accrue interest at 6% annually. Upon termination, members can elect a refund of their contributions plus accumulated interest. Vested terminated members who are eligible to retire can also elect a lump-sum payment equal to the present value of their accrued benefits. Either action results in the member's forfeiture of rights to further accrued benefits.

At June 30, 2005, plan membership totaled 188,790, comprised of 124,642 active members, 22,671 inactive members (terminated vested employees entitled to benefits but not yet receiving them), and 41,477 retirees and beneficiaries currently receiving benefits. The active members include 71,367 current employees who are fully vested and 53,275 nonvested current employees covered by the plan. A total of 24,452 terminated nonvested employees are not members of the plan but are eligible for a refund.

The funding policy of the Regents of the University of California (regents) provides for actuarially determined contributions at rates that provide for sufficient assets to be available when benefits are due. The contribution rate is determined using the entry age normal actuarial funding method. The significant actuarial assumptions used to compute the actuarially determined contribution are the same as those used to compute the actuarial accrued liability.

The annually determined rates for employer contributions as a percentage of payroll are based on recommendations of the consulting actuary and on appropriations received from the primary government.

Employees may be required to contribute to the UCRP. The rate of employee contributions is established annually as a percentage of covered wages, pursuant to the regents' funding policy, recommended and certified by an enrolled, independent actuary and approved by the regents, the plan's trustee. During the year ended June 30, 2005, employee contributions to the UCRP were redirected to the University of California Defined Contribution Plan.

For the year ended June 30, 2005, there were no employer contributions, annual pension costs, or net pension obligations. The annual pension cost was equal to the actuarially determined contribution.

The actuarial value of assets was determined using techniques that smooth the effect of short-term volatility in the fair value of investments over a five-year period. The actuarial value of assets in excess of the actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at June 30, 2005, was three years.

The PERS-VERIP is a defined benefit pension plan providing lifetime supplemental retirement income and survivor benefits to members of the University of California CalPERS program (UC-PERS) who elected early retirement under provisions of the plan. The university contributed to the CalPERS program on behalf of these UC-PERS members. At June 30, 2005, there were 785 retirees or beneficiaries receiving benefits under this voluntary early retirement program. The cost of contributions made to the plan is borne entirely by the university and the U.S. Department of Energy laboratories. Over the five-year period ended June 30, 1996, the university and the U.S. Department of Energy laboratories were required to make contributions to the plan sufficient to maintain the promised benefits and the qualified status of the plan, as determined by the plan's consulting actuary.

The University of California Retirement Savings Program includes three defined contribution plans (Defined Contribution Plan, Tax Deferred 403(b) Plan, and Tax Deferred 457(b) Plan) providing savings incentives and additional retirement security that are generally available to all University employees. Participants' interests in the plans are fully and immediately vested and are distributable at death, retirement or termination of employment. Participants may also elect to defer distribution of the account until age 70 1/2 or separation from service after age 70 1/2, whichever is later, in accordance with Internal Revenue Code minimum distribution requirements. The Plans also accept pretax rollover contributions from other 401(a), 401(k), 403(b) and governmental 457(b) Plans.

The Defined Contribution Plan (the DC Plan) accepts both after-tax and pretax contributions. Pretax contributions are fully vested and are mandatory for all employees who are members of the UCRP. Monthly employee contributions range from approximately 2% to 4% of covered wages depending upon whether wages are below or above the Social Security wage base. The university has a provision for matching employer and employee contributions to the DC Plan for certain summer session teaching or research compensation for eligible academic employees. Employer contributions to the DC Plan were $3.5 million for the year ended June 30, 2005.

The university's Tax Deferred 403(b) Plan (the 403(b) Plan) accepts pretax contributions. In October 2004, the university established a Tax Deferred 457(b) Plan (the 457(b) Plan) to accept pretax contributions. There are no employer contributions to the 403(b) Plan and the 457(b) Plan.

Participants in the DC Plan and the 403(b) Plan may direct their elective and nonelective contributions to investment funds managed by the treasurer of the regents. Participants may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis. The participants' interest in external mutual funds is shown separately on the statement of the plans' fiduciary net assets. Participants in the 457(b) Plan may direct their elective contributions only to investment funds managed by the treasurer.

Additional information on the retirement plans can be obtained from the 2004-05 annual reports of the UCRP, the PERS-VERIP, the University of California Retirement Savings Plans. These reports may be obtained from the University of California, Office of the President – HR/Benefits Dept., Financial Services and Plan Disbursements, 300 Lakeside Drive, Suite 400, Oakland, California 94612.

The annual required contribution for the current year was determined as part of the June 30, 2005, actuarial valuation, which is the latest available information, using the entry age normal actuarial cost method. Significant actuarial assumptions used in the valuation are shown in Table 42. Information from the last valuation is also shown in Table 42.

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Table 42

Actuarial Information – Pension Trusts – Primary Government
June 30, 2005

	Public Employees' Retirement Fund	Judges' Retirement Fund	Judges' Retirement II Fund
Last actuarial valuation	June 30, 2004	June 30, 2004	June 30, 2004
Actuarial cost method	Individual Entry Age Normal	Aggregate Cost	Aggregate Entry Age Normal
Amortization method	Level % of Payroll, Closed	None	Level % of Payroll, Closed
Remaining amortization period	22 to 30 years	None	Average of 30 Years
Asset valuation method	Smoothed Market Value	Market Value	Smoothed Market Value
Actuarial assumption			
Investment rate of return	7.75 %	7.00 %	7.25 %
Projected salary increase	3.25 - 19.95	3.25	3.25
Includes inflation at	3.00	3.00	3.00
Post-retirement benefit increases	2 - 5	3.25	3.00
Annual pension costs (in millions)			
Year ended 6/30/03	$ 1,172	$ 186	$ 15.9
Year ended 6/30/04	2,121	191	18.6
Year ended 6/30/05	2,480	184	21.2
Percent contribution			
Year ended 6/30/03	100 %	53 %	96 %
Year ended 6/30/04	100	57	102
Year ended 6/30/05	100	69	100
Net pension obligation (in millions)			
Year ended 6/30/03	—	$ 987	—
Year ended 6/30/04	—	1,069	—
Year ended 6/30/05	—	1,127	—
Funding as of last valuation (in millions)			
Actuarial value – assets	$ 67,081	N/A	$ 129.2
Actuarial accrued liabilities (AAL) – entry age	79,800	N/A	137.7
Excess of actuarial value of assets over AAL (EAV) (unfunded actuarial accrued liability (UAAL))	(12,719)	N/A	(8.5)
Covered payroll	12,624	N/A	99
Funded ratio	84.1 %	N/A	93.8 %
EAV (UAAL) as percent of covered payroll	100.8 %	N/A	8.6 %

* The State is a non-employer contributor to the State Teacher's Retirement Defined Benefit Program Fund, a cost-sharing multiple-employer plan. The annual pension cost includes the amount related to both the State and the local government employers. The notion of ARC and NPO does not apply to cost-sharing employer plans. According to the provisions of the Education Code, the State and local government employers contributed $595 million and $2.0 billion, respectively, for the year ending June 30, 2005. Based on the most recent actuarial valuation, dated June 30, 2004, current statutory contributions are sufficient to fund normal costs but are not expected to be sufficient to amortize the unfunded actuarial obligation. However, future estimates of the actuarial unfunded obligation may change due to market performance, legislative actions, and other experience that may differ from the actuarial assumptions.

Legislators' Retirement Fund	State Teachers' Retirement Defined Benefit Program Fund *	University of California Retirement Plan Fund	Voluntary Early Retirement Incentive Plan Fund
June 30, 2004	June 30, 2004	June 30, 2005	June 30, 2005
Aggregate Cost	Entry Age Normal	Entry Age Normal	Unit Credit
None	Level % of Payroll, Open	Level % of Payroll, Open	N/A
None	Not amortizable	3 Years	N/A
Smoothed Market Value	Expected Value, With 33% Adjustment to Market Value	Smoothed Fair Value	Fair Value
7.00 %	8.00 %	7.50 %	7.50 %
3.25	4.25	4.5 - 6.5	N/A
3.00	3.25	4.00	4.00
3.00	2.00	N/A	N/A
$ —	$ 2,545	—	—
—	3,539	—	—
—	3,836	—	—
— %	91 %	N/A	N/A
—	67	N/A	N/A
—	68	N/A	N/A
$ 10	—	—	—
10	—	—	—
10	—	—	—
N/A	$ 114,094	$ 41,085	$ 77.8
N/A	138,254	37,252	45.8
N/A	(24,160)	3,833	32.0
N/A	23,764	8,150	—
N/A	82.5 %	110.3 %	169.8 %
N/A	101.7 %	47.0 %	—

NOTE 24: POST-RETIREMENT HEALTH CARE BENEFITS

Health care and dental benefits are provided by the primary government and certain discretely presented component units, to annuitants of retirement systems to which the primary government contributes as an employer. The discretely presented component units' participation in these plans is not a material portion of the program. To be eligible for these benefits, first-tier plan annuitants must retire on or after age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within 120 days of separation from employment to be eligible to receive these benefits. As of June 30, 2005, approximately 124,700 annuitants were enrolled to receive health benefits and approximately 101,700 annuitants were enrolled to receive dental benefits. In accordance with the California Government Code, the primary government generally pays 100% of the health insurance cost for annuitants, plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the California Government Code does not specify the primary government's contribution toward dental insurance costs, the primary government generally pays all or a portion of the dental insurance cost for annuitants, depending upon the completed years of credited state service at retirement and the dental coverage selected by the annuitant. The primary government recognizes the cost of providing health and dental insurance to annuitants on a pay-as-you-go basis. The cost of these benefits for the year ended June 30, 2005, was approximately $800 million.

Also, the University of California, a discretely presented component unit, provides to retired employees certain health plan benefits in addition to pension benefits. Employees who meet specific requirements may continue their medical and dental benefits into retirement and continue to receive University of California contributions for those benefits. There are approximately 39,600 retirees eligible to receive such benefits. The cost of retiree medical and dental coverage is recognized when paid. The cost of providing medical and dental benefits for retirees and their families and survivors for the year ended June 30, 2005, was $193 million.

NOTE 25: SUBSEQUENT EVENTS

The following information describes significant events that occurred subsequent to June 30, 2005, but prior to the date of the auditor's report.

The primary government issued $4.0 billion in general obligation bonds to retire previously issued commercial paper, to repay internal state loans, and to finance various school, prison, water, housing, library, transportation, and children's hospital projects. The primary government also issued revenue anticipation notes of $3.0 billion that are due to be redeemed in June 2006.

The Regents of the University of California issued $911 million in General Revenue Bonds to finance and refinance certain facilities and projects of the university. They also issued $616 million in Limited Project Revenue Bonds to finance and refinance the acquisition, construction, renovation, and improvements of certain auxiliary enterprises of the university.

The California State University issued Systemwide Revenue Bonds in the amount of $676 million for construction projects and to refund certain bonds, including $28 million in debt of the discretely presented auxiliary organizations.

The Department of Water Resources issued $2.6 billion in Supply Power Revenue Bonds. It also issued $112 million in Central Valley Project Water System Revenue Bonds to advance refund $105 million of outstanding bonds and to redeem $12 million of commercial paper borrowings.

The California Infrastructure and Economic Development Bank issued State School Fund Apportionment Lease Revenue Bonds totaling $97 million and Infrastructure State Revoloving Fund Revenue Bonds totaling $53 million.

The State Public Works Board, an agency whose activities are accounted for as an enterprise fund, issued lease revenue bonds totaling $735 million for the benefit of the University of California and various state agencies. Of the bond proceeds, $470 million will be used to refund outstanding bonds.

The San Francisco State Building Authority and the Oakland State Building Authority, whose activities are accounted for as capital project funds, issued lease revenue refunding bonds totaling $201 million and $28 million, respectively.

The Golden State Tobacco Securitization Corporation issued $3.1 billion in Enhanced Tobacco Settlement Asset-Backed Bonds. Of the bond proceeds, $2.6 billion will be used to refund outstanding bonds.

In July 2005, Fitch Ratings raised its rating on California's general obligation bonds from A- to A and Moody's Investor Service upgraded California's general obligation bonds to A2 from A3.

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Required Supplementary Information

Schedule of Funding Progress [1]

Public Employees' Retirement Fund - Primary Government

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2002	$ 62,201	$ 68,854	$ (6,653)	90.3 %	$ 12,425	(53.5) %
June 30, 2003	62,515	74,450	(11,935)	84.0	12,628	(94.5)
June 30, 2004	67,081	79,800	(12,719)	84.1	12,624	(100.8)

Judges' Retirement Fund II

(amounts in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2002	$ 71,929	$ 76,459	$ (4,530)	94.1 %	$ 72,804	(6.2) %
June 30, 2003	96,107	105,116	(9,009)	91.4	87,295	(10.3)
June 30, 2004	129,153	137,704	(8,551)	93.8	99,005	(8.6)

State Teachers' Retirement Defined Benefit Program [2]

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2001	$ 107,654	$ 109,881	$ (2,227)	98.0 %	$ 20,585	(10.8) %
June 30, 2003	108,667	131,777	(23,110)	82.5	23,862	(96.8)
June 30, 2004	114,094	138,254	(24,160)	82.5	23,764	(101.7)

[1] Actuarial valuations for the Judges' Retirement Fund and the Legislators' Retirement Fund are performed using the aggregate actuarial cost valuation method. The schedule of funding progress is not required if this method is used.

[2] Except for 2004, actuarial valuations are not prepared in even-numbered years. No estimation using actuarial methodology is made in years between valuations.

University of California Retirement System

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2003	$ 41,429	$ 32,955	$ 8,474	125.7 %	$ 7,734	109.6 %
June 30, 2004	41,293	35,034	6,259	117.9	7,835	79.9
June 30, 2005	41,085	37,252	3,833	110.3	8,150	47.0

Infrastructure Assets Using the Modified Approach

Pursuant to Governmental Accounting Standards Board (GASB), Statement No. 34, the State has adopted the Modified Approach as an alternative to depreciating the cost of its infrastructure (state roadways and bridges). Under the Modified Approach, the State will not report depreciation expense for roads and bridges but will capitalize all costs that add to the capacity and efficiency of State-owned roads and bridges. All maintenance and preservation costs will be expensed and not capitalized.

A. Infrastructure Asset Reporting Categories

The infrastructure assets reported in the State's financial statements for the fiscal year ending June 30, 2005, are in the following categories and amounts: state highway infrastructure (completed highway projects), totaling $55.1 billion; land purchased for highway projects, totaling $11.1 billion; and infrastructure construction-in-progress (uncompleted highway projects), totaling $3.8 billion.

Donation: Donation and relinquishment activity affects the inventory of statewide lane miles, land, and/or bridges as adjustments to the infrastructure assets and/or land balance in the State's financial statements. Although the State does not believe that these activities are material, it is developing processes and procedures to measure and report donation and relinquishment activity beginning with the fiscal year ending June 30, 2006, as required by GASB No. 34.

B. Condition Baselines and Assessments

The State is providing condition assessments starting with the fiscal year ending June 30, 2004, because that was the first year the information was required. In succeeding years, the State will add the previous fiscal years' condition assessments until the most recent and two previous condition assessments are reported, as required by GASB No. 34.

1. Bridges

The State is using the Bridge Health Index — a numerical rating scale from 0% to 100% that utilizes element-level inspection data — to determine the aggregate condition of its bridges. The inspection data is based on the American Association of State Highway Transportation Officials' (AASHTO) "Commonly Recognized Structural Elements Standard."

From a deterioration standpoint, the Bridge Health Index represents the remaining asset value of the bridge. A new bridge that has 100% of its asset value will have a Bridge Health Index of 100%. As a bridge deteriorates over time, it loses asset value as represented by a decline in its Bridge Health Index. When a deteriorated bridge is repaired, it will regain some (or all) of its asset value and its Bridge Health Index will increase, possibly to 100%.

The State's established condition baseline and actual Bridge Health Index for fiscal years 2003-04 and 2004-05 are as follows:

Fiscal Year Ending June 30	Established BHI Condition Baseline*	Actual BHI Condition
2004	80.0%	94.2%
2005	80.0%	94.3%

* The actual statewide Bridge Health Index (BHI) should not be lower than the minimum BHI established by the State.

The following table provides details on the State's actual Bridge Health Index and condition baseline as of June 30, 2005.

BHI Description	Bridge Count	Percent	Network BHI
Excellent	6,625	54.84 %	99.9 %
Good	4,303	35.62	96.1
Acceptable	799	6.61	87.2
Fair	183	1.51	75.7
Poor	171	1.42	60.6
Total	**12,081**	**100.00 %**	

2. Roadways

The State is using AASHTO "Pavement Performance Data Collection Protocols" in its annual pavement condition survey, which evaluates ride quality and structural integrity and is used to identify the number of distressed lane miles. The State classifies its roadways' pavement condition by the following descriptions:

1. Excellent/good condition – minor or no potholes or cracks.
2. Fair condition – moderate potholes and cracks.
3. Poor condition – significant or extensive potholes or cracks.

Statewide lane miles are considered "distressed lane miles" if they are in either fair or poor condition. The actual distressed lane miles are compared to the established condition baseline to ensure it is not exceeded.

The State's established condition baseline and the actual distressed lane miles for fiscal years 2003-04 and 2004-05 are as follows:

Fiscal Year Ending June 30	Established Condition Baseline Distressed Lane Miles (maximum)*	Actual Distressed Lane Miles	Actual Distressed Lane Miles as Percent of Total Lane Miles
2004	18,000	11,824	24.0 %
2005	18,000	12,624	25.5 %

* The actual statewide distressed lane miles should not exceed the maximum distressed lane miles established by the State.

The following table provides details on the pavement condition of the State's roadways as of June 30, 2005.

Pavement Condition	Lane Miles	Distressed Lane Mile
Excellent/Good	36,937	—
Fair	241	241
Poor	12,383	12,383
Total	**49,561**	**12,624**

C. Budgeted and Actual Preservation Costs

The State is providing only budgeted and actual preservation costs starting with the fiscal year ending June 30, 2004, instead of the last five fiscal years because that was the first year that this information was required. In succeeding years, the State will add the previous fiscal years' budgeted and actual preservation cost information until the number of fiscal years being reported reaches five, as required by GASB No. 34.

Fiscal Year Ending June 30	Estimated Budgeted Preseservation Costs (in millions)	Actual Preservation Costs (in millions)
2004	$ 975	$ 717
2005	$ 1,049	$ 821

Budgetary Comparison Schedule

General Fund and Major Special Revenue Funds

Year Ended June 30, 2005
(amounts in thousands)

	General			
	Budgeted Amounts		Actual	Variance With
	Original	Final	Amounts	Final Budget
REVENUES				
Corporation tax	$ —	$ —	$ 8,670,065	$ —
Intergovernmental	—	—	—	—
Cigarette and tobacco taxes	—	—	119,055	—
Inheritance, estate, and gift taxes	—	—	213,035	—
Insurance gross premiums tax	—	—	2,232,954	—
Vehicle license fees	—	—	21,586	—
Motor vehicle fuel tax	—	—	—	—
Personal income tax	—	—	42,738,009	—
Retail sales and use taxes	—	—	25,758,635	—
Other major taxes and licenses	—	—	316,907	—
Other revenues	—	—	1,909,716	—
Total revenues	**—**	**—**	**81,979,962**	**—**
EXPENDITURES				
State and consumer services	513,693	539,055	521,494	17,561
Business and transportation	14,098	14,221	13,956	265
Resources	696,853	787,242	777,451	9,791
Health and human services	25,644,444	25,884,800	24,786,559	1,098,241
Correctional programs	6,170,875	6,797,433	6,766,828	30,605
Education	40,907,459	41,116,693	40,931,873	184,820
General government:				
Tax relief	952,005	951,730	948,707	3,023
Debt service	3,152,278	3,152,641	3,122,107	30,534
Other general government	4,119,261	2,035,201	1,836,647	198,554
Total expenditures	**82,170,966**	**81,279,016**	**79,705,622**	**1,573,394**
OTHER FINANCING SOURCES (USES)				
Transfers from other funds	—	—	359,902	—
Transfers to other funds	—	—	(203,917)	—
Other additions and deductions	—	—	83,821	—
Total other financing sources (uses)	**—**	**—**	**239,806**	**—**
Excess (deficency) of revenues and other sources over (under) expenditures and other uses	—	—	2,514,146	—
Fund balances (deficits), July 1, 2004 (restated)	**—**	**—**	**7,408,514**	**—**
Fund balances (deficits), June 30, 2005	**$ —**	**$ —**	**$ 9,922,660**	**$ —**

Federal				Transportation Construction			
Budgeted Amounts		Actual	Variance With	Budgeted Amounts		Actual	Variance With
Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
—	—	39,398,373	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	895,772	—
—	—	—	—	—	—	3,366,141	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	3	—
—	—	—	—	—	—	—	—
—	—	284	—	—	—	270,450	—
—	**—**	**39,398,657**	**—**	**—**	**—**	**4,532,366**	**—**
6,166	6,166	6,166	—	1	1	—	1
2,585,701	2,585,701	2,585,701	—	4,717,594	4,803,744	4,653,044	150,700
214,602	214,602	214,602	—	12	12	12	—
27,632,442	27,632,442	27,632,442	—	—	—	—	—
33,124	33,124	33,124	—	—	—	—	—
6,715,604	6,715,604	6,715,604	—	980	980	980	—
—	—	—	—	—	—	—	—
—	—	—	—	500	500	85	415
1,053,881	1,053,881	1,053,881	—	176,244	180,441	178,944	1,497
38,241,520	**38,241,520**	**38,241,520**	**—**	**4,895,331**	**4,985,678**	**4,833,065**	**152,613**
—	—	5,281,869	—	—	—	5,860,221	—
—	—	(6,429,065)	—	—	—	(5,695,511)	—
—	—	(3,172)	—	—	—	80,000	—
—	**—**	**(1,150,368)**	**—**	**—**	**—**	**244,710**	**—**
—	—	6,769	—	—	—	(55,989)	—
—	**—**	**4,161**	**—**	**—**	**—**	**3,215,162**	**—**
$ —	**$ —**	**$ 10,930**	**$ —**	**$ —**	**$ —**	**$ 3,159,173**	**$ —**

Reconciliation of Budgetary Basis Fund Balances of the General Fund and the Major Special Revenue Funds to GAAP Basis Fund Balances

June 30, 2005
(amounts in thousands)

		Special Revenue Funds	
	General	Federal	Transportation Construction
Budgetary fund balance reclassified into GAAP statement fund structure	**$ 9,922,660**	**$ 10,930**	**$ 3,159,173**
Basis difference:			
Interfund receivables	151,979	—	628,900
Loans receivable	101,003	41,735	—
Interfund payables	(2,268,511)	—	—
Escheat property	(1,011,800)	—	—
Other	(7,264)	—	(1,649)
Timing difference:			
Liabilities budgeted in subsequent years	(6,701,210)	(25,637)	(100,510)
GAAP fund balance, June 30, 2005	**$ 186,857**	**$ 27,028**	**$ 3,685,914**

Notes to the Required Supplementary Information

Budgetary Comparison Schedule

The State annually reports its financial condition based on GAAP (GAAP basis) and on the State's budgetary provisions (budgetary basis). The Budgetary Comparison Schedule, General Fund and Major Special Revenue Funds, reports the original budget, the final budget, the actual expenditures, and the variance between the final budget and the actual expenditures, using the budgetary basis of accounting.

On a budgetary basis, individual appropriations are charged as expenditures when commitments for goods and services are incurred. However, for financial reporting purposes, the State reports expenditures based on the year in which goods and services are received. The Budgetary Comparison Schedule includes all of the current-year expenditures for the General Fund and major special revenue funds and their related appropriations that are legislatively authorized annually, continually, or by project. On a budgetary basis, adjustments for encumbrances are budgeted under other general government, while the encumbrances relate to all programs' expenditures.

The Budgetary Comparison Schedule is not presented in this document at the legal level of budgetary control because such a presentation would be extremely lengthy and cumbersome. The State of California prepares a separate report, the *Budgetary/Legal Basis Annual Report Supplement*, which includes statements that demonstrate compliance with the legal level of budgetary control in accordance with GASB's *Codification of Governmental Accounting and Financial Reporting Standards*, Section 2400.121. The Statement of Appropriations, Expenditures, and Balances and the Comparative Statement of Actual and Budgeted Expenditures include the comparison of the annual appropriated budget with expenditures at the legal level of control. The Federal Fund, which is a major special revenue fund, and certain programs of the Transportation Construction Fund are not included in the *Budgetary/Legal Basis Annual Report Supplement* statements because they are considered fiduciary fund activities on the budgetary basis. A copy of the *Budgetary/Legal*

Basis Annual Report Supplement is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

Reconciliaton of Budgetary Basis With GAAP Basis

The reconciliation of Budgetary Basis fund balances of the General Fund and the major special revenue funds to GAAP Basis fund balances are presented on the previous page and are explained in the following paragraphs.

The beginning fund balances for the General Fund, Federal Fund, and Transportation Construction Fund on the budgetary basis are restated for prior-year revenue adjustments and prior-year expenditure adjustments. A prior-year revenue adjustment occurs when the actual amount received in the current year differs from the amount of revenue accrued in the prior year. A prior-year expenditure adjustment results when the actual amount paid in the current year differs from the prior-year accrual for appropriations whose ability to encumber funds has lapsed in previous periods. The beginning fund balance on a GAAP basis is not affected by these adjustments.

Basis Difference

Interfund Receivables and Loans Receivable: Loans made to other funds or to other governments are normally recorded as expenditures on the budgetary basis. However, in accordance with GAAP, these loans are recorded as assets. The adjustments related to interfund receivables caused a $152 million increase to the fund equity in the General Fund and a $629 million increase to the fund equity in the Transportation Construction Fund. The adjustments related to loans receivable caused increases of $101 million in the General Fund and $42 million in the Federal Fund.

Interfund Payables: Loans received from other funds are normally recorded as revenues on a budgetary basis. However, in accordance with GAAP, these loans are recorded as liabilities. The adjustments related to interfund payables caused a $2.3 billion decrease to the budgetary fund balance in the General Fund.

Escheat Property: A liability for the estimated amount of escheat property expected to ultimately be reclaimed and paid is not reported on a budgetary basis. The liability is required to be reported in the interfund payables on a GAAP basis. This adjustment caused a $1.0 billion decrease to the General Fund balance.

Other: Certain other adjustments and reclassifications are necessary in order to present the financial statements in accordance with GAAP. The other adjustments caused a fund balance decreases of $7 million in the General Fund and $2 million in the Transportation Construction Fund.

Timing Difference

Liabilities Budgeted in Subsequent Years: On a budgetary basis, the primary government does not accrue liabilities for which there is no existing appropriation or no currently available appropriation. The adjustments made to account for these liabilities in accordance with GAAP caused fund balance decreases of $6.7 billion in the General Fund, $26 million in the Federal Fund, and $101 million in the Transportation Construction Fund. The large decrease in the General Fund primarily consists of $1.7 billion for deferred apportionment payments to K-12 schools and community colleges, $1.5 billion of tax amnesty program overpayments, $1.4 billion for medical assistance, and $1.2 billion for the repayment of the vehicle license fee gap loan to local governments.

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Part Two

State of California: Internal Control and State and Federal Compliance Audit Report for the Year Ended June 30, 2005

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AUDITOR’S SECTION

Independent Auditor's Reports on Internal Control and on Compliance and Other Matters

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's 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

The Governor and the Legislature of
the State of California

We have audited the basic 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, 2005, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated February 28, 2006. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 49 percent, and 51 percent, respectively, of the assets, net assets and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.
- Certain nonmajor enterprise funds that represent 87 percent, 78 percent, and 85 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, is based on the reports of the other auditors. We conducted our audit in accordance with 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 of America.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the State of California's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State of California's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2005-19-1 through 2005-19-3.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the State of California's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. 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 that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the governor and Legislature of the State of California, the management of the executive branch, and the federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BUREAU OF STATE AUDITS

PHILIP J. JELICICH, CPA
Deputy State Auditor

February 28, 2006

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133

The Governor and the Legislature of
the State of California

COMPLIANCE

We have audited the compliance of the State of California with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2005. The State of California's major federal programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the State of California's management. Our responsibility is to express an opinion on the State of California's compliance based on our audit.

The State of California's basic financial statements include the operations of the University of California and the California State University systems, as well as the California Housing Finance Agency, a component unit authority of the State. However, these entities are not included in the accompanying schedule of findings and questioned costs or schedule of federal assistance for the year ended June 30, 2005. The University of California and the California State University systems, and the California Housing Finance Agency, which reported expenditures of federal awards totaling $3.1 billion and $1.2 billion, and $74.1 million, respectively, engaged other auditors to perform an audit in accordance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133).

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence

about the State of California's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of the State of California's compliance with those requirements.

As described in item 2005-8-4 in the accompanying schedule of findings and questioned costs, the State of California did not comply with requirements regarding period of availability that are applicable to its Centers for Disease Control and Prevention—Investigations and Technical Assistance (CFDA Number 93.283). Compliance with such requirements is necessary, in our opinion, for the State of California to comply with requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, the State of California complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2005. The results of our auditing procedures also disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs. See the attachment for a list of these issues.

INTERNAL CONTROL OVER COMPLIANCE

The management of the State of California is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the State of California's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the State of California's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs. The attachment also contains a list of these issues.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over

compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

SCHEDULE OF FEDERAL ASSISTANCE

We have audited 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, 2005, and have issued our report thereon dated February 28, 2006. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 49 percent, and 51 percent, respectively, of the assets, net assets and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.
- Certain nonmajor enterprise funds that represent 87 percent, 78 percent, and 85 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, is based on the reports of the other auditors. We conducted our audit in accordance with 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 of America.

Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The accompanying schedule of federal assistance is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. OMB Circular A-133 requires the schedule of federal assistance to present total expenditures for each federal assistance program. However, although the State's automated accounting system separately identifies receipts for each federal assistance program, it does not separately identify expenditures for each program. As a result, the State presents the schedule of federal assistance on a cash receipts basis. In addition, the schedule of federal assistance does not include expenditures of federal awards received by the University of California and the California State University systems, or the California Housing Finance Agency. These expenditures are audited by other independent auditors in accordance with OMB Circular A-133. The information in the accompanying schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the governor and Legislature of the State of California, the management of the executive branch, and the federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

February 28, 2006

Attachment

ATTACHMENT

The compliance issues are:

2005-1-1
2005-2-1
2005-2-2
2005-2-3
2005-2-4
2005-3-1
2005-3-2
2005-3-4
2005-3-5
2005-3-6
2005-5-1
2005-5-3
2005-8-1
2005-8-2
2005-8-3
2005-8-4
2005-12-1
2005-12-2
2005-12-3
2005-12-6
2005-13-1
2005-13-2
2005-13-3
2005-13-4
2005-13-6
2005-14-1
2005-14-3
2005-14-4
2005-14-5

The internal control over compliance issues are:

2005-2-2
2005-2-3
2005-3-1
2005-3-2
2005-3-3
2005-3-4
2005-3-5
2005-3-6
2005-5-2
2005-7-1
2005-7-2
2005-9-1
2005-9-2
2005-9-3
2005-12-2
2005-12-3
2005-12-4
2005-12-5
2005-12-6
2005-13-2
2005-13-3
2005-13-6
2005-14-1
2005-14-2
2005-14-3

Schedule of Findings and Questioned Costs

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005

Summary of Auditor's Results

Financial Statements

Type of report issued by auditors	Unqualified
Internal control over financial reporting:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	No

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Type of reports the auditor issued on compliance for major programs:	
Centers for Disease Control and Prevention—Investigations and Technical Assistance (93.283)	Qualified
All other major programs	Unqualified
Any audit findings disclosed that are required to be reported in accordance with Section .510(a) of Circular A-133?	Yes
Dollar threshold used to distinguish between Type A and Type B programs	$70.3 million
Auditee qualified as low-risk auditee?	No

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster of Programs
	Aging Cluster
	Child Care Cluster
	Child Nutrition Cluster
	Employment Services Cluster
	Food Stamp Cluster
	Highway Planning and Construction Cluster
	Medicaid Cluster
	Special Education Cluster
	Student Financial Aid Cluster
	Workforce Investment Act Cluster
10.550	Food Donation
10.557	Special Supplemental Nutrition Program for Women, Infants, and Children
10.558	Child and Adult Care Food Program
14.239	HOME Investment Partnerships Program
16.575	Crime Victim Assistance
17.225	Unemployment Insurance
66.468	Capitalization Grants for Drinking Water State Revolving Funds
84.002	Adult Education—State Grant Program
84.010	Title I Grants to Local Educational Agencies
84.011	Migrant Education—Basic State Grant Program
84.048	Vocational Education—Basic Grants to States
84.126	Rehabilitation Services—Vocational Rehabilitation Grants to States
84.287	Twenty-First Century Community Learning Centers
84.318	Education Technology State Grants
84.357	Reading First State Grants
84.365	English Language Acquisition Grants
84.367	Improving Teacher Quality State Grants
93.268	Immunization Grants
93.283	Centers for Disease Control and Prevention—Investigations and Technical Assistance
93.558	Temporary Assistance for Needy Families
93.563	Child Support Enforcement
93.568	Low-Income Home Energy Assistance
93.569	Community Services Block Grant
93.658	Foster Care—Title IV-E
93.659	Adoption Assistance
93.767	State Children's Insurance Program
93.917	HIV Care Formula Grants
93.959	Block Grants for Prevention and Treatment of Substance Abuse
97.004 (formerly 16.007)	State Domestic Preparedness Equipment Support Program
97.036	Public Assistance Grants
97.039	Hazard Mitigation Grant

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

VARIOUS STATE DEPARTMENTS

Reference Number: 2005-19-1

CONDITION

State departments do not always report their employees' taxable fringe benefits and business expense reimbursements. Federal and state tax laws require that employers report income and related tax amounts for payments other than regular wages, including fringe benefits and business expense reimbursements. Fringe benefits—cash, property, or services received in addition to regular pay—are reportable as taxable income unless specifically excluded or deferred in Internal Revenue Service (IRS) regulations. Examples of such taxable reimbursements include mileage compensation for commuting or personal travel between home and office when employees must work overtime (overtime or callback mileage), payment for employees' meals when they must work overtime or travel for 24 hours or less without lodging, and the value of personal use of state vehicles.

The State Controller's Office (Controller's Office) informs state departments through its Payroll Procedures Manual and its Payroll Letters of the IRS and state requirements for reporting taxable fringe benefits and taxable business expenses. State departments must report these employee fringe benefits and business expense reimbursements to the Controller's Office by the 10th of the month following the month in which the payments were made. The Controller's Office then calculates and deducts the required taxes.

Despite these requirements, some state departments did not consistently ensure that all employees' taxable benefits or taxable business expense reimbursements were being reported to the Controller's Office. We reviewed the reporting of employee taxable benefits and reimbursements at four previously unreviewed state departments for fiscal year 2004-05 in addition to following up on concerns we reported for other departments for fiscal year 2003-04. We summarize the results of this testing in the table included in this finding.

We reviewed from 47 to 241 travel expense claims at each of the four additional entities to determine whether the departments properly reported employee taxable reimbursements. However, not all of these travel expense claims included claims for taxable benefits. Three of the four additional state departments that we reviewed, the Commission on Peace Officer Standards and Training (Commission), the State Personnel Board (Board), and the Secretary of State, did not always ensure that they met the reporting requirements the Controller's Office described.

For the additional four state departments we also determined if those departments that issued vehicle home storage permits reported the personal use of state vehicles to the Controller's Office. Two of the four departments that we reviewed, the Commission and the Board, did not always ensure that they reported the personal use of state vehicles to the Controller's Office or that staff using vehicles provided

adequate documentation to determine what trips constituted personal use. The Commission has asserted to us that it has only one state vehicle that is currently assigned to its executive director on a permanent basis.

In addition, three of the additional four state departments that we reviewed have not fully established written policies and procedures. In particular, the Commission has not developed written procedures to help ensure that it consistently and correctly reports taxable fringe benefits. The Board also has not established such policies, except for its policies concerning personal use of state vehicles. Moreover, the Secretary of State followed an unwritten policy to report the benefits once a year, in December. Although the Secretary of State had not fully developed written policies and procedures during the period that we reviewed, it subsequently developed written procedures that, if followed, appear adequate to ensure proper reporting to the Controller's Office.

We reported similar concerns for fiscal year 2003-04 at four other departments—the Department of Corrections and Rehabilitation (Corrections and Rehabilitation), the Department of Fish and Game (Fish and Game), the Department of Health Services (Health Services), and the Department of Industrial Relations (Industrial Relations). We performed a follow-up review of the reporting of employee taxable benefits and reimbursements at these state departments generally for January 2005 to June 2005, the period since our last review. We reviewed 180 travel expense claims at Fish and Game and 177 at Health Services and found that these departments again did not always report to the Controller's Office taxable fringe benefits arising from employees' travel and overtime expense reimbursements.

Our current review determined that Fish and Game, Health Services, and Corrections and Rehabilitation established written procedures that require the reporting to the Controller's Office of all taxable benefits arising from personal use of a state vehicle. We believe the procedures, if followed, are adequate to ensure compliance with the reporting requirements of personal use of state vehicles. However, Industrial Relations continued to lack written procedures to help ensure that it consistently and correctly reports taxable fringe benefits. In addition, Fish and Game still has not developed written procedures for taxable fringe benefits arising from employees' travel and overtime expense reimbursements. A Fish and Game accounting supervisor has asserted to us that Fish and Game uses the Payroll Procedures Manual, which it believes is written very clearly, to serve as its policies and procedures. However, because Fish and Game continues to have inadequate reporting of taxable fringe benefits, we believe its own department-specific policies and procedures are warranted.

Industrial Relations, Health Services, and Corrections and Rehabilitation's Northern Region again also did not always ensure that they reported the personal use of state vehicles to the Controller's Office or that staff using vehicles provided adequate documentation to determine what trips constituted personal use. Additionally, Industrial Relations was unable to provide a complete list of employees with home storage permits and was able to provide mileage logs for only 33 of at least 76 employees using state vehicles.

Corrections and Rehabilitation's Northern Region believed that its agents were exempt from reporting personal use of state vehicles under certain circumstances based on its view of IRS regulations. However, to qualify as exempt, specific conditions must be satisfied and documented by actual facts and circumstances. For unmarked law enforcement vehicles to qualify, any personal use must be both authorized and incident to law enforcement functions, such as reporting directly from home to a stakeout or surveillance site, or to an emergency situation. Travel directly between home and headquarters would not be exempt from reporting. Further, Corrections and Rehabilitation's April 2004 procedure states that it cannot issue a blanket certification for all employee assigned vehicles nor automatically continue exemption status to a qualifying employee who later changes his assignment and no longer meets the Internal Revenue Services' criteria. The procedure also states that routine commuting by a peace officer in an unmarked law enforcement vehicle between home and headquarters does not qualify for exemption from reporting commute miles as a taxable benefit. Moreover, its July 2005 procedure states that all use of an unmarked law enforcement vehicle that is not incident to a stakeout or surveillance site, or to an emergency situation must be reported. Our review of the Northern Region's documents, such as home storage permits and related vehicle mileage logs, found personal commutes that were not reported to the Controller's Office, even though the documents show clear and consistent use of the vehicles for commuting.

Table

Reportable Items Reviewed That Were Not Reported to the Controller's Office in Fiscal Year 2004-05

State Agency	Total Number of Travel Expense Claims With Reportable Items Reviewed	Items Not Reported		
		Overtime/ Callback Mileage	Meals for Travel of 24 Hours or Less/Overtime Meals	Employees with Personal Use of State Vehicle*
Commission	5**	0	5	1
Corrections and Rehabilitation	N/A	N/A	N/A	5***
Fish and Game	15	0	49	2
Health Services	21	N/A	6	8
Industrial Relations	N/A	N/A	N/A	4
Secretary of State	89	6	17	0
State Personnel Board	13	0	9	4
TOTALS	**143**	**6**	**86**	**24**

Note: Some travel expense claims contained more than one type of reportable item.
N/A: We did not review this area because, in our prior year audit, we did not report noncompliance.
*Personal use of state vehicles is reported on documents separate from travel expense claims.
**Because the Commission stated that it did not report any benefits during fiscal year 2004-05, we reviewed a limited number of travel expense claims to substantiate that benefits exist.
***Because corrections and rehabilitation's northern region believed that its agents were exempt from reporting personal use of state vehicles, we reviewed a limited number of employees' home storage permits and related mileage logs to substantiate that benefits exist.

When state departments do not properly report their employees' taxable benefits and business expense reimbursements, the Controller's Office cannot calculate and withhold the related tax, as required by federal and state laws and regulations.

CRITERIA

The Controller's Office Payroll Procedures Manual, sections 120 through 176, provides procedures for reporting to the Controller's Office taxable fringe benefits and business expense reimbursements provided to state employees. These procedures are based on federal and state tax laws. The following benefits and payments included in this manual relate to our testing of agency compliance:

- Section 129.1 states that the use of state-owned or state-leased vehicles for personal commutes between home and office is reportable taxable income.

- Section 129.1.3 describes an IRS exemption for unmarked law-enforcement vehicles if the use of the vehicle is authorized by the department owning the vehicle and employing the officer and is to law enforcement functions and the actual facts and circumstances are documented.

- Section 130.1.2 states that reimbursements to employees for commuting expenses, such as for expenses from commuting or personal travel between home and office, is considered taxable income. This includes callback and overtime mileage.

- Section 143.3 states that overtime meal compensation is reportable and constitutes taxable income.

- Section 145.1.2 states that meal reimbursements for travel of 24 hours or less without lodging is taxable income. Simply stated, if an employee receives reimbursement for meals during travel in which there was no overnight stay, this reimbursement is taxable income.

RECOMMENDATION

All state departments should ensure that they have procedures established and implemented to properly report taxable fringe benefits and taxable employee business expense reimbursements.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

The Commission concurs with our finding and states that it is in the process of developing policies and procedures.

The Secretary of State concurs with our finding. It states that it has implemented procedures to report taxable fringe benefits on a monthly basis as required, and began monthly reporting effective January 2006. It also states that it will continue to update its policies and procedures to ensure full compliance with applicable rules and regulations.

The Board concurs with our finding and states that it will develop written procedures to provide guidance on properly reporting taxable fringe benefits and taxable business reimbursements. The board also states that it will distribute these procedures to all staff with assignments in this area and provide training.

Corrections and Rehabilitation concurs with our finding and indicates that it has issued Financial Information Memo 2005-09 and implemented a process to report personal use of qualified law enforcement vehicles. Among other steps, the process requires a record of facts and circumstances to determine personal use. Corrections and Rehabilitation expresses its commitment to enforce this process. It further states that periodic spot compliance reviews will be conducted to ensure that staff appropriately completes the required forms.

Fish and Game concurs with our finding and states that it will develop and implement procedures to properly report to the Controller's Office taxable fringe benefits arising from personal use of state-owned or state-leased vehicles, and overtime reimbursements. In addition, Fish and Game will advise its personnel of withholding and reporting obligations associated with these benefits.

Health Services concurs with our findings and states that, by June 30, 2006, it will implement the California Automated Travel Expense Reimbursement System that will automatically report taxable items from travel expense claims for all employees. In addition, Health Services states that, in May 2005, it implemented a system that requires all employees to report personal use of state-owned or state-leased vehicles.

Industrial Relations concurs with our finding. It intends to implement written procedures, by early next fiscal year, to ensure that taxable fringe benefits are properly reported.

DEPARTMENT OF FISH AND GAME

Reference Number: 2005-19-2

CONDITION

For the fiscal year ending June 30, 2004, we reported that the Department of Fish and Game (Fish and Game) had inadequate procedures for accounting and reporting its real property. We noted that Fish and Game's Land and Facilities Branch is

responsible for reporting information on land to the Department of General Services (General Services) to be included in the Statewide Property Inventory and for reconciling with the Statewide Property Inventory. Its Fiscal and Administrative Services Branch, Property Unit had the same responsibilities for buildings and improvements. Its accounting unit reported real property information to the State Controller's Office (Controller's Office) for inclusion in the State's financial statements. Fish and Game also accounted for and reported real property information for the Wildlife Conservation Board (board), using the same agency number for both agencies in the Statewide Property Inventory.

For fiscal year 2001-02, the two branches did not reconcile their data with the Statewide Property Inventory. Further, the two branches and the accounting unit did not reconcile the property listings and Statement of Changes in General Fixed Assets. Also, the accounting unit reported incorrect information to the Controller's Office. Specifically, we determined the following:

- For the year ending June 30, 2002, Fish and Game's property listings for itself and the board had land of approximately $490.1 million, while the Statewide Property Inventory recorded approximately $97.6 million more.
- As of June 30, 2002, the Statements of Changes in General Fixed Assets reported land, buildings, and improvements approximately $105.3 million greater than the property listings showed. For the year ended June 30, 2002, the accounting unit reported real property of approximately $164.3 million that may not have represented completed asset purchases.
- The accounting unit overstated land additions in the board's Statement of General Fixed Assets by at least $2.5 million by including cash grants given to a non-state entity. For fiscal year 2002-03, Fish and Game inappropriately reported $65.9 million in cash grants as land additions and understated the gift value of land by $46.1 million.

For fiscal years 2003-04 and 2004-05, Fish and Game indicated to us that it had not fully implemented our prior recommendations. As a result, we did not conduct additional audit work except to determine whether Fish and Game currently reported selected changes to its real property inventory.

Unless Fish and Game reconciles its property listings to the Statewide Property Inventory, reconciles its property listings to its Statement of General Fixed Assets, and reports complete and accurate information to the Controller's Office and General Services, the State's financial statements will be misstated and the Statewide Property Inventory will be incomplete and inaccurate.

CRITERIA

The California Government Code, Section 11011.15, requires each agency to furnish General Services with a record of each parcel of real property that it possesses and to update its real property holdings by July 1 each fiscal year. It also requires General Services to maintain a complete and accurate inventory of all real property held by the

State. General Services includes Fish and Game's information in the Statewide Property Inventory. In addition, the State Administrative Manual, Section 7924, requires agencies to annually reconcile the amounts reported in the Statewide Property Inventory with the Statement of Changes in General Fixed Assets.

Additionally, the State Administrative Manual, sections 7463, 7977, and 8660, requires agencies to report to the Controller's Office in a Statement of Changes in General Fixed Assets all additions and deductions to real property funded by governmental funds. The Controller's Office includes this information in the State's financial statements.

RECOMMENDATIONS

To ensure that it reports complete and accurate information for the State's financial statements and the Statewide Property Inventory, Fish and Game should:

- Annually reconcile amounts it reports for the Statewide Property Inventory with its and the board's Statements of Changes in General Fixed Assets.
- Report in the Statement of Changes in General Fixed Assets real property that has been acquired on or before the end of the fiscal year.
- Report in the Statement of Changes in General Fixed Assets only real property acquired for the State.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Fish and Game concurs with our finding and indicates that it has made progress in addressing the recommendations, but additional time is necessary for full implementation. Specifically, Fish and Game states that it capitalized $327.6 million of the backlog in property listings during fiscal year 2004-05, established procedures for land capitalization, and started a training program for its staff. Fish and Game also states that it plans, among other tasks, to capitalize all land acquisition costs, including donations, mitigation and grants; develop procedures to compare asset reports on a monthly basis; and reconcile differences between its and General Services' Statewide Property Inventory databases. Fish and Game anticipates that its research and data collection to reconcile the various databases will take a minimum of twelve months. Once the reconciliation is complete, it intends to assign one staff the task of developing a plan to bring current and maintain all databases by June 30, 2007. In addition, Fish and Game states that it will post donated land as an asset immediately upon the receipt of the land acquisition memo from the board. Finally, Fish and Game states that a recommendation for change in procedure for non-state assets has been submitted to management.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2005-19-3

CONDITION

For the fiscal year ending June 30, 2004, we reported that the Department of Parks and Recreation (Parks and Recreation) continued to have inadequate procedures to account for and report its real property. Specifically, its acquisition unit had not reported $3.4 million in ancillary costs for the real property acquired between July 2001 and June 2002, and it did not report ancillary costs to the Department of General Services (General Services) in a format that allows input into the Statewide Property Inventory system. In addition, Parks and Recreation did not reconcile the amounts reported in the Statewide Property Inventory system with its records. In December 2004, in an attempt to reconcile the two sources, Parks and Recreation acknowledged an unexplained difference of approximately $167 million between its and General Service's Statewide Property Inventory account balances for land. In its corrective action plan, Parks and Recreation had stated that it would work with General Services to develop a process to include ancillary costs in the Statewide Property Inventory system and that it had initiated a process to reconcile the amounts reported in the Statewide Property Inventory system with its Statement of Changes in General Fixed Assets.

In December 2005 we followed up with Parks and Recreation to determine whether it reports ancillary costs to General Services for inclusion in the Statewide Property Inventory system. Parks and Recreation informed us that it had not reported the $3.4 million in ancillary costs of real property acquired in fiscal year 2001-02, and still does not report ancillary costs to General Services in a format that allows input into the Statewide Property Inventory system. In December 2005 Parks and Recreation also informed us that it has not fully implemented our prior years' recommendation to reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets.

Unless Parks and Recreation reports complete and accurate ancillary cost information to General Services, and periodically reconciles its Statement of Changes in General Fixed Assets with the Statewide Property Inventory records, the State's financial statements may be misstated and the Statewide Property Inventory will be incomplete and inaccurate.

CRITERIA

The State Administrative Manual, Section 8611, requires that all costs related to purchasing land be included in the capitalized amount. This includes ancillary costs such as legal and title fees, title search costs, and costs of grading, surveying, draining, etc.

The California Government Code, Section 11011.15, requires each agency to furnish General Services with a record of each parcel of real property that it possesses and to update its real property holdings by July 1 each fiscal year. It also requires General Services to maintain a complete and accurate inventory of all real property held by the State. General Services includes Parks and Recreation's information in the Statewide Property Inventory. In addition, the State Administrative Manual, Section 7924, requires agencies to annually reconcile the amounts reported in the Statewide Property Inventory with the Statement of Changes in General Fixed Assets.

Additionally, the State Administrative Manual, sections 7463, 7977, and 8660, requires agencies to report to the Controller's Office in a Statement of Changes in General Fixed Assets all additions and deductions to real property funded by governmental funds. The Controller's Office includes this information in the State's financial statements.

RECOMMENDATIONS

We recommend that Parks and Recreation take the following actions:

- Report ancillary costs to General Services in a form acceptable for inclusion in the Statewide Property Inventory.
- Reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Parks and Recreation concurs with our findings and indicates that its acquisition and audit staff have agreed on a policy and method of compiling and reporting ancillary costs to General Services' Statewide Property Inventory in a format acceptable to their system. It expects to compile and report ancillary costs for fiscal years 2001-02 through 2004-05 before June 30, 2006. Parks and Recreation also indicates that it has completely reconciled its structures assets and continues to reconcile the land assets, resulting in an unexplained difference of $104.9 million as of January 2006. Parks and Recreation believes that, due to the extent of research necessary for each item to be reconciled, it will take a long time to complete its reconciliation.

Compliance Issue Related to All Federal Grants

IDENTIFYING PROGRAM EXPENDITURES

Reference Number:	2005-12-1
Federal Program:	All Programs
Category of Finding:	Reporting

CRITERIA

In our review of federal reports, we determined the following were among state and federal compliance requirements:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires that the State prepare a schedule showing total expenditures for the year for each federal program. Further, OMB Circular A-133 requires that the State identify and audit all high-risk Type A federal programs. Type A programs are those exceeding .15 percent of total federal program moneys the State expends during the fiscal year. The California Government Code, Section 13300, assigns the Department of Finance (Finance) the responsibility for maintaining a complete accounting system to ensure that all revenues, expenditures, receipts, disbursements, resources, obligations, and property of the State are properly tracked and reported.

CONDITION

Because of limitations in its automated accounting systems, the State has not complied with the provision of OMB Circular A-133 requiring a schedule showing total expenditures for each federal program. As a result, the schedule (beginning on page 121) shows total receipts, rather than expenditures, by program. Expenditure information is necessary to identify Type A programs. To ensure that we identified and audited all high-risk Type A programs, we reviewed accrual basis expenditures, which are identified manually, for all programs that we did not already plan to audit and that had cash receipts within 10 percent of the Type A program threshold. We identified four such programs. Our review of the expenditures of these programs showed that they did not exceed the Type A threshold.

RECOMMENDATION

As priorities and resources permit, Finance should modify the State's accounting system to separately identify expenditures for all major programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Finance states that the State's accounting system will require substantial modification to compile expenditure information to meet all federal and State requirements. Because the State has limited resources, Finance has no plans at this time to enhance the State's accounting system or to implement a new system.

Compliance and Internal Control Issues Related to Specific Grants Administered by Federal Departments

U.S. DEPARTMENT OF AGRICULTURE

Reference Number:	2005-13-1
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2004 7CA700CA7; 2005
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program) identified the following compliance requirements related to subrecipient monitoring:

The Code of Federal Regulations, Title 7, Section 246.19(b)(4), requires the State to promptly notify a local agency of any finding resulting from a monitoring review, and the State must require the local agency to submit a corrective action plan within 60 days of receipt of the State's findings. This section also requires the State to monitor the local agencies' implementation of the corrective action plan to ensure that subrecipients take appropriate and prompt corrective action. The Department of Health Services' (Health Services) WIC Program manual requires local agencies to submit the corrective action plan within 60 days of receiving Health Services' letter of findings and recommendations.

CONDITION

Health Services does not ensure the prompt resolution of all findings resulting from its monitoring reviews of local agencies' administration of their WIC programs. For four of the 35 local agencies with findings that we reviewed the corrective action plans were not submitted until more than 180 days after the exit conference, which marks the end of the review. One of these was submitted 361 days after the exit conference. Both Health Services and local agencies contributed to delays. For example, although Health Services requires local agencies to submit a corrective action plan within 60 days after they receive a letter of finding, it can take Health Services several weeks to issue these letters. In particular, Health Services took more than 90 and as much as 137 days after the exit conferences to send these letters to seven of the 35 local agencies. Additionally, nine of the 35 local agencies did not submit their corrective

action plans within 60 days after receipt of the letters. The delays ranged from 11 to 281 days, averaging 64 days late. As a result of these delays, Health Services cannot always ensure that its subrecipients correct deficiencies promptly.

According to the section chief responsible for the monitoring reviews, beginning in July 2005, Health Services has issued letters of findings more promptly because it has streamlined its process for reviewing and approving the letters of findings. Additionally, according to the section chief responsible for ensuring that local agencies take appropriate corrective action, local agencies sometimes are delayed in providing a corrective action plan because they have other priorities or do not have staff with the necessary experience in preparing a corrective action plan. Thus, Health Services' staff often will assist the local agencies in preparing the corrective action plan, which may take longer than the 60 days.

RECOMMENDATIONS

Health Services should continue to improve its efforts to issue letters of findings promptly. Additionally, it should continue to work with the local agencies to ensure that they submit corrective action plans by the required 60 days.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees with the audit recommendations. In response to last year's audit finding, Health Services streamlined its process and since July 2005 is sending letters of findings in less than 90 days following the completion of performance reviews. Health Services appreciates the Bureau of State Audits' recognition of this accomplishment.

Health Services, on the other hand, was not successful in all attempts to obtain corrective action plans (CAP) within the required 60 days due to staffing vacancies. Health Services recently filled several vacancies in the WIC Branch and anticipates it will have the staff resources to enforce the policy requiring local agencies to submit their CAP within 60 days following issuance of findings. Enforcement will include closely tracking and monitoring local agencies subject to corrective action, clarifying local agency responsibilities to complete the CAP, and enforcing contract provisions regarding failure to perform. Health Services plans to implement these steps by April 1, 2006.

U.S. DEPARTMENT OF JUSTICE

Reference Number:	2005-12-3
Federal Catalog Number:	16.575
Federal Program Title:	Crime Victim Assistance
Federal Award Numbers and Calendar Years Awarded:	2000-VA-GX-0006; 2000 2001-VA-GX-0006; 2001 2002-VA-GX-0006; 2002 2003-VA-GX-4025; 2003 2004-VA-GX-0009; 2004
Category of Finding:	Reporting
State Administering Department:	Governor's Office of Emergency Services

CRITERIA

Our review of the Crime Victim Assistance program identified the following compliance requirements related to reporting:

The Code of Federal Regulations, Title 28, Section 66.20, requires the Governor's Office of Emergency Services (Emergency Services) to maintain accounting records to track properly and report accurately financial activities related to federal grants. Additionally, Section 66.41 requires Emergency Services to submit financial status reports showing all program outlays and program income. Lastly, the final program guidelines established by the U.S. Department of Justice's Office of Justice Programs require Emergency Services to periodically submit specific grant performance data for the Crime Victim Assistance program.

CONDITION

Certain reports Emergency Services submitted in fiscal year 2004-05 do not comply with applicable reporting requirements. For instance, amounts on Emergency Services' final financial status report for the 2002 grant year do not agree with the accounting records. In an April 2005 letter accompanying the final financial status report, Emergency Services told the U.S. Department of Justice that several amounts in the final financial status report were not derived from its accounting records or those of the Office of Criminal Justice Planning, which administered the Crime Victim Assistance program until December 2003. Rather, Emergency Services based amounts in the final financial status report on direction and data provided by the U.S. Department of Justice. As we reported last year, Emergency Services assumed administration of the Crime Victim Assistance program from the Office of Criminal

Justice Planning. Emergency Services stated that it found many of the program's accounting records to be inaccurate or non-existent. Emergency Services then contracted with the Department of Finance to reconstruct the accounting records. Although the Department of Finance has completed its work, Emergency Services had not completed, as of January 2006, posting the adjustments required by the reconstruction. According to the chief of its Fiscal Management Branch, Emergency Services plans to intensify its focus on posting the adjustments in January 2006 and will establish by the end of January a completion date for this work. Emergency Services plans to develop a revised final financial status report for the 2002 award year if the U.S. Department of Justice requires it. Because the unposted transactions could apply to funds from the 2000 and 2001 award years, revised final financial status reports for these two award years also may be necessary.

In another instance, a performance report submitted by Emergency Services to the U.S. Department of Justice included incorrect performance data on an annual report covering federal fiscal year 2003-04. Among other things, Emergency Services is required to provide data on this performance report showing the number of victims served in a variety of categories. Of the five categories we reviewed, we determined that Emergency Services reported materially inaccurate data for one category. Specifically, Emergency Services' performance report showed that 95,989 victims received criminal justice support and advocacy services. However, the supporting documentation showed that these services were provided to 275,097 victims, a difference of 179,108. This error occurred because of weak controls to ensure the report's accuracy. For instance, according to the chief of its Victim Services Branch, Emergency Services has no written procedures that describe how it will compile this report.

RECOMMENDATIONS

When Emergency Services completes the posting of the adjustments necessary from the reconstruction of the program's accounting records, it should submit revised final financial status reports, if necessary. Also, Emergency Services should implement sufficient internal controls to ensure that performance data included in the annual reports submitted to the federal government are accurate.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services agrees with the financial status report finding and recommendation. Upon completion and posting of all reconstruction adjustments, Emergency Services will revise and or prepare all required federal financial status reports, as needed.

Regarding performance reports, Emergency Services agrees with the finding. The corrective action is as follows:

1. Emergency Services has requested that our project manager for the federal Victims of Crime Act (VOCA) provide training to staff on how to complete the VOCA state performance report. Specifically, training is required on interpreting the VOCA definitions as they relate to the services provided and victims served with VOCA funds in California.

2. A representative from each section has volunteered to be on a committee to correlate the statistics requested on our progress reports with the appropriate categories and definitions requested on the VOCA state performance report. A matrix will be developed indicating each of the VOCA categories/definitions with the corresponding objective information from our progress reports.

3. Instructions for staff are also being developed on how the data is to be collected and reported for the VOCA state performance report. This will insure consistency among sections.

4. The Victim Services Branch has instituted internal controls regarding the documentation that is retained to support the data supplied on the VOCA state performance report. In 2003-04 these controls were lacking and some of the supporting documentation was missing from the branch files. Now, this supporting documentation is not only retained at the branch level but also by the federal funds project manager.

U.S. DEPARTMENT JUSTICE
U.S. DEPARTMENT OF HOMELAND SECURITY

Reference Number:	2005-13-2
Category of Finding:	Subrecipient Monitoring
State Administering Departments:	Governor's Office of Emergency Services[1] Governors' Office of Homeland Security

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Crime Victim Assistance, State Domestic Preparedness Equipment Support, Public Assistance Grants, and Hazard Mitigation Grant programs identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires subrecipients spending $500,000 or more in federal assistance in fiscal years ending after December 2003 to submit audit reports to the State within nine months of the end of their fiscal year. The State is responsible for notifying subrecipients of the applicable audit requirements. Additionally, the State requires subrecipients to submit audit reports to the State Controller's Office (Controller's Office) or the appropriate state department so corrective action can be taken on reported deficiencies. If an audit finds that a subrecipient has failed to comply with federal program requirements, OMB Circular A-133 also requires the State to issue a management decision regarding the resolution of the audit finding within six months of receiving the audit report and to ensure that the subrecipient proceeds with prompt corrective action.

CONDITION

The Governor's Office of Emergency Services (Emergency Services) did not adequately monitor subrecipients of funds for the Crime Victim Assistance, State Domestic Preparedness Equipment Support, Public Assistance Grants, and Hazard Mitigation Grant programs. Specifically, during fiscal year 2004-05, Emergency Services did not ensure that it received or reviewed audit reports submitted by private nonprofit organizations that expended $500,000 or more in federal assistance in fiscal year 2003-04 and therefore could not follow up on identified findings. Further, Emergency Services did not follow up on findings for audit reports provided by the

[1] Until March 2005, the Governor's Office of Emergency Services administered the State Domestic Preparedness Equipment Support Program. Beginning in March 2005, the Governor's Office of Homeland Security took over this program's administration.

Controller's Office regarding local governmental subrecipients that spent $500,000 or more in federal assistance in fiscal year 2003–04. The Controller's Office receives audit reports for local governmental entities and, if the reports contain findings, forwards copies to the state agencies responsible for administering the programs to follow up with the local governmental subrecipients to ensure that identified weaknesses are corrected.

The number of unreviewed OMB Circular A-133 audit reports and findings varies depending on the grant. For example, Emergency Services' management auditor who is responsible for reviewing audit reports and findings related to the Crime Victim Assistance program estimated there was a total backlog of 500 unreviewed reports, including audit reports submitted by nonprofit entities and findings from audit reports provided by the Controller's Office. There were about 18 boxes of unreviewed audit reports and findings for the Public Assistance Grants and Hazard Mitigation Grant programs, according to the chief of Emergency Services' Grants Management Branch, but Emergency Services could not determine the exact amount.

Because Emergency Services did not ensure that audit reports were received and did not review audit reports it did receive, it could not ensure that subrecipients were complying with federal program requirements or that weaknesses identified in the audit reports were corrected promptly. According to the chief of its Grants Management Branch, Emergency Services has not reviewed the OMB Circular A-133 reports due to lack of staffing.

Finally, Emergency Services did not follow up adequately on the results of site visits it conducted for subrecipients of funds from the Crime Victim Assistance program. Specifically, for eight of the 10 on-site monitoring reviews we examined, we found that Emergency Services did not obtain corrective action plans from subrecipients or did not document whether it had followed up with subrecipients to ensure that deficiencies identified during the site visits were corrected. Consequently, Emergency Services could not ensure that its subrecipients corrected deficiencies promptly.

RECOMMENDATIONS

Emergency Services and the Governor's Office of Homeland Security (Homeland Security) should review nonprofit subrecipients' audit reports promptly. Further, they should ensure that identified weaknesses are corrected promptly.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

***Emergency Services**:*

Emergency Services agrees that it did not fulfill all OMB Circular A-133 pass-through agency requirements for the Crime Victim Assistance, Public Assistance and Hazard Mitigation Grants. Emergency Services does not have adequate staffing levels to perform all required OMB Circular A-133 subrecipient monitoring for these grants.

Emergency Services will continue to request additional positions for this activity and the finding will remain uncorrected until adequate positions are received.

Additionally, Emergency Services agrees that it did not fulfill all OMB Circular A-133 pass-through agency requirements for the State Domestic Preparedness Equipment Support program for the period July 1, 2004, through March 31, 2005. Homeland Security assumed all programmatic and administrative responsibility for this grant on April 1, 2005. Consequently, Emergency Services cannot provide a response for Homeland Security's actions performed on or after April 1, 2005, and Emergency Services does not have the responsibility for implementing a corrective action plan for the finding as it relates to this grant.

Regarding follow up on site visits, immediately after the Victim Services Branch manager received notification from the Bureau of State Audits (BSA) of the finding in November 2004, the following corrective action was taken:

First, although the former Office of Criminal Justice Planning (OCJP) had a Grants Management Information System (GMIS) that tracked the date of site visits, it did not track satisfactory resolution of deficiencies that were identified during site visits. Adding this element to GMIS would have been an easy fix; however, after OCJP was abolished effective January 1, 2004, and became a division under Emergency Services, GMIS was no longer maintained. As a result, the Branch developed a new tracking process through an Excel spreadsheet as a management information tool. Staff were to enter and update site visit information for fiscal year 2004/05 for each grant recipient on the spreadsheet. Once the BSA finding regarding site visits surfaced, the following items were added to the Excel spreadsheet for tracking purposes: "Last Site Visit, Form Completed, Corrective Action Plan Status, Scheduled Visits, and Last Monitoring."

Second, managers developed or revised independent methods of tracking and managing information within their section regarding site visits, some of which were more detailed than the Branch spreadsheet. For instance, one section developed a form entitled, "Site Visit Report Check List" which tracks the following information: "Grantee, Site Visit Date, Letter Sent to Grantee, Report Given to Section Chief, Correction Action Plan Due Date, Corrective Action Received Approved, and Reminder Contact." It should be noted that the Victim Services Branch intends to consolidate the independent methods each section is using into one working document and process for consistency purposes, and staff from each section are coordinating this effort.

Third, as a consequence of Senate Bill 914 (added by Chapter 840, Statutes of 2004), and codified as Penal Code sections 13823.15, 13823.16 and 13837.1, Staff Instructions were developed for the Domestic Violence Assistance and Rape Crisis Programs regarding site visits. The instructions specify how to prepare for a site visit to include entering the scheduled date on the spreadsheet; instructions on how to cancel and reschedule a site visit and entering this information on the spreadsheet; conducting the site visit and identifying issues found to be deficient; sending a follow-up letter within 60 days summarizing the results of the site visits that identifies the deficiencies that need to be addressed; reasons the deficiencies must be

addressed; corrective action required of the grant recipient; timeline by which the corrective action must be completed; Emergency Services review process to ensure corrective action has been completed within six months (which may include material/document submission and/or future on-site review); sample documents that may be of assistance in correcting identified deficiencies with the letter; and the submission of the letter and completed site visit form to the supervisor for review, signature and date. The Staff Instructions also provide information on follow-up and satisfactory completion of corrective action in which within 30 days of satisfactory completion, a letter is sent to the grant recipient indicating the project is in full compliance with all program requirements, and a copy is sent to the Emergency Services Grant File. Additionally, the Staff Instructions provide a format for the corrective action letter which includes three components for each finding, i.e. Finding; Citation; and Corrective Action.

These staff instructions and accompanying site visit forms are in draft format but have been reviewed by Emergency Services' Legal Counsel. The Domestic Violence and Sexual Assault sections have pilot tested them during site visits and the forms are being slightly revised. It is anticipated that final versions will be approved by March 2006. Should the forms be successful, it is anticipated they may be used for all of the programs in the Branch in the future.

Finally, despite the tools mentioned above, Emergency Services continues to have problems with adequately following up and documenting the results of site visits conducted. Although mechanisms are in place, the Victim Services Branch was staffed at approximately 70% capacity due to first a hiring freeze, and then a pause in hiring. Since the Branch was short staffed and had varying competing priorities, proper documentation and follow up with respect to site visits was sometimes neglected. This issue is currently being resolved as the Victim Services Branch is in the process of hiring staff, although staff retention has also become a new concern.

***Homeland Security**:*

For applicable audits ending March 2005, Homeland Security has made arrangements to receive the reports directly. Homeland Security has implemented procedures for reviewing the reports in order to identify any potential findings that affect it. If any findings are identified and are applicable to Homeland Security, a letter will be sent to the auditee requiring the submission of a corrective action plan within sixty days of the audit report date. Additionally, Homeland Security has implemented procedures for identifying whether or not a report has been received by the nine-month deadline. If a report is not received, Homeland Security will follow-up with a letter to the auditee requiring proof of exemption from the single audit requirement, or the submission of a report no later 15 days from receipt of notification. When deemed appropriate, Homeland Security will conduct a monitoring visit to ensure that identified weaknesses are corrected and issue a management decision within six months.

Although not required, Homeland Security has reviewed all audit reports released to it by Emergency Services; cataloged them by auditee, noted findings if applicable, and if required, receipt of corrective action plans.

U.S. DEPARTMENT OF JUSTICE

Federal Catalog Number:	16.575
Federal Program Title:	Crime Victim Assistance
Federal Award Numbers and Calendar Years Awarded:	2003-VA-GX-4025; 2003 2004-VA-GX-0009; 2004

U.S. DEPARTMENT OF HOMELAND SECURITY

Federal Catalog Number:	97.004 (formerly 16.007)
Federal Program Title:	State Domestic Preparedness Equipment Support Program
Federal Award Numbers and Calendar Years Awarded:	2002-TE-CX-0088; 2002 2002-TE-CX-0133; 2002 2003-TE-TX-0167; 2003 2003-MU-T3-0035; 2003 2004-GE-T4-0045; 2004

Federal Catalog Number:	97.036
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2004-05

Federal Catalog Number:	97.039
Federal Program Title:	Hazard Mitigation Grant Program
Year Awarded:	State fiscal year 2004-05

U.S. DEPARTMENT OF LABOR

Reference Number: 2005-2-2

Category of Finding: Allowable Costs and Cost Principles

State Administering Department: Employment Development Department

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of federal programs at the Employment Development Department (EDD) identified the following compliance requirements related to allowable costs and cost principles:

The U.S. Office of Management and Budget Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87), Attachment A, Section C, states that for costs to be allowable under federal awards, they must be allocable to federal awards under the provisions of this circular. This is the case if the goods or services involved are chargeable or assignable to a grant in accordance with the relative benefits received. Section C also states that when an accumulation of indirect costs ultimately will result in charges to a federal award, a cost allocation plan will be required, as described in OMB Circular A-87, Attachments C, D, and E. OMB Circular A-87, Attachment E, Section A, states that indirect costs are incurred for common or joint purposes. These costs benefit more than one cost objective and cannot be readily identified with a particular final cost objective without effort disproportionate to the results achieved.

CONDITION

EDD allocated five of 10 operating expense and equipment (OE&E) transactions we reviewed, even though it had not obtained federal approval to do so as part of its indirect cost rate proposal. The five allocated transactions included OE&E expenses such as equipment rental, repair, and maintenance; software purchasing and maintenance; and data processing equipment. According to EDD, it used the allocation codes to distribute OE&E costs that it could not identify specifically with a particular federal program. Consequently, EDD should have included and distributed these allocated costs under its indirect cost rate proposal.

Costs related to the five test items totaled $131,481. Although we could not determine the amount of allocated costs charged to the federal programs we audited, according to EDD, in fiscal year 2004-05 it used 65 allocation codes to distribute personnel costs and 91 allocation codes to distribute OE&E costs totaling more than $59 million and $38 million, respectively. These allocated costs were not included in EDD's indirect cost rate proposal. In total, the allocated costs represented 8.5 percent of EDD's estimated total state operations expenditures of more than $1.1 billion for fiscal year 2004-05. When

EDD does not distribute indirect costs under an indirect cost rate proposal, it is less likely to demonstrate adequately that these costs are distributed in accordance with the relative benefits received by its various federal programs. We reported a similar finding during our audits for fiscal years 1998-99 through 2003-04.

In its indirect cost rate proposal for fiscal year 2005-06, EDD included documentation to support its use of allocated costs and, as of December 2005, is working with the U.S. Department of Labor to obtain approval of its indirect cost rate proposal.

RECOMMENDATION

EDD should continue to work with the U.S. Department of Labor to obtain approval of its fiscal year 2005-06 indirect cost rate proposal.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

On June 30, 2005, EDD submitted the indirect cost rate proposal for the period July 1, 2005 through June 30, 2006 to the U.S. Department of Labor Regional Cost Negotiator (RCN) for review and approval. The indirect cost rate proposal describes all cost pools that the EDD began using starting July 1, 2005. The use of cost pools eliminates the need for 151 allocation codes. The indirect cost rate proposal explains how costs will be distributed to programs in accordance with benefits received per federal regulations.

EDD met with RCN after the original submission. The RCN agreed with the basis for most of EDD's cost pool allocations, and identified only limited areas of concern. One concern was how EDD allocated shared tax-processing costs. The RCN believed there is a need to revisit the current "tax sharing ratio" considering the most recent agreement was established in fiscal year 1991-92. The RCN also believed EDD should allocate shared costs based on "character" count rather than "fields".

A revised indirect cost rate proposal was submitted on December 7, 2005, with the understanding EDD was still developing information regarding the tax-sharing ratio. EDD is in the process of capturing the character counts for the employer tax reporting forms. After the character count is gathered, we will be able to identify the percentages for the benefiting tax programs. We anticipate this analysis will be completed in February 2006.

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-13985-04-55; 2004

Federal Catalog Number:	17.801
Federal Program Title:	Disabled Veterans' Outreach Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2004

Federal Catalog Number:	17.804
Federal Program Title:	Local Veterans' Employment Representative Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2004

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Number and Calendar Year Awarded:	UI-14423-05-55; 2004

Federal Catalog Number:	17.258
Federal Program Title:	WIA Adult Program
Federal Award Number and Calendar Year Awarded:	AA137870450; 2004

Federal Catalog Number:	17.259
Federal Program Title:	WIA Youth Activities
Federal Award Number and Calendar Year Awarded:	AA137870450; 2004

Federal Catalog Number:	17.260
Federal Program Title:	WIA Dislocated Workers
Federal Award Number and Calendar Year Awarded:	AA137870450; 2004

Reference Number:	2005-12-5
Category of Finding:	Reporting
State Administering Department:	Employment Development Department

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of federal programs at the Employment Development Department (EDD) identified the following compliance requirement related to reporting:

The Code of Federal Regulations, Title 29, Section 97.41(c), requires state agencies to submit an accurate SF 272 Federal Cash Transactions Report (SF 272) no later than 15 working days after the end of each quarter to the U.S. Department of Labor (Labor) for it to monitor cash advanced to the grantee and obtain disbursement information for the Labor grants.

CONDITION

EDD did not have a process in place to review the accuracy of a reconciliation it used to complete its quarterly SF 272 reports. As a result, EDD reported incorrect financial information in SF 272 reports for June 2005. Specifically, EDD overstated net disbursements and cash on hand by more than $870,000. This error occurred because EDD used inaccurate data when preparing the periodic reconciliation of its cash management system with its accounting system.

RECOMMENDATION

To ensure that it submits accurate financial information in its quarterly SF 272s, EDD should establish a process to review the reconciliation of its cash management system with its accounting system.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The reported "Net Disbursements" amount of $119,698,058.73 in the June 2005 SF 272 report was overstated by approximately $870,000. It is correct that the overstatement was due to an error on a reconciliation.

Since this error was discovered, EDD has taken steps to ensure the reconciliation is accurate. Staff will review existing reconciliation mechanisms (cell formulas) to "double-check" their work. Depending on what is displayed in the cell formulas, staff

can be alerted of potential discrepancies and a need to review the accuracy of the reconciliation. We believe this step will reduce the likelihood of errors on the supporting schedule and on the SF 272.

Please note that to the best of our knowledge, all information on SF 272 reports prior and subsequent to June 2005 was accurate.

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-13985-04-55; 2004

Federal Catalog Number:	17.801
Federal Program Title:	Disabled Veterans' Outreach Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2004

Federal Catalog Number:	17.804
Federal Program Title:	Local Veterans' Employment Representative Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2004

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Number and Calendar Year Awarded:	UI-14423-05-55; 2004

U.S. DEPARTMENT OF TRANSPORTATION

Reference Number:	2005-9-2
Federal Catalog Number:	20.205
Federal Program Title:	Highway Planning and Construction
Federal Award Number and Calendar Year Awarded:	N4520.180; 2005
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Transportation

CRITERIA

Our review of the Highway Planning and Construction program identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 49, Section 18.35, requires that the State neither can make an award nor permit a subgrantee to make an award to any party that is debarred or suspended from participating in federal assistance programs. Further, Title 49, Section 29.300, states that before entering into a covered transaction with another party, recipients of federal funds must verify that the other party has not been suspended or debarred by checking the Excluded Parties List System (EPLS), collecting a certification from the other party, or adding a clause or condition to the covered transaction with that party. As its method of verification, the California Department of Transportation (Caltrans) includes a provision in its agreements with other parties, which serves as a certification that the other party has not been suspended or debarred (suspension and debarment provision).

CONDITION

Although Caltrans included the suspension and debarment provision in all seven of its agreements with private contractors that we tested, it did not always include such a provision in its agreements with local governments (subrecipients). Specifically, we found that Caltrans did not include a suspension and debarment provision in its agreements with five of the 12 subrecipients we tested. In response to a similar finding we reported during our fiscal year 2003-04 audit, Catrans stated that it implemented procedures in February 2005 to meet federal regulations by incorporating a suspension and debarment provision in its agreements with subrecipients. Of the 12 subrecipient agreements we tested, Caltrans entered into eight of them during or after February 2005, and all but one of the eight included the suspension and debarment provision. When Caltrans does not comply fully with its

verification procedures, it risks unknowingly allowing suspended and debarred parties to participate in the federal program. For the five subrecipients whose agreements did not contain the suspension and debarment provision, we reviewed the EPLS and found that none of them were suspended or debarred.

RECOMMENDATION

Before it enters into agreements with subrecipients Caltrans should verify that those subrecipients are allowed to participate in federal assistance programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Caltrans has implemented corrective action and will continue to ensure sub-recipients have not been suspended or debarred from participating in federal assistance programs. In February 2005, as an interim measure, the Caltrans Division of Local Assistance, Office of Project Implementation (OPI), began inserting the following standard clause in all program supplement agreements (PSAs) with its federal fund recipient local agencies:

> "ADMINISTERING AGENCY certifies that neither the ADMINISTERING AGENCY nor its principals are suspended or debarred at the time of execution of this agreement. ADMINISTERING AGENCY agrees that it will notify the STATE immediately, in the event a suspension or debarment occurs after execution of this agreement."

To simplify the certification process in the future, OPI is developing a new Master Agreement for all federally funded projects. The revised Master Agreement, which is expected to be completed by June 2006, will include the above language and will be sent to all federal fund recipient agencies for execution. With the incorporation of the above certified language in the revised Master Agreement, it will no longer be necessary to include the clause in local agencies' future PSAs.

U.S. ELECTION ASSISTANCE COMMISSION

Reference Number:	2005-2-3
Federal Catalog Number:	39.011
Federal Program Title:	Election Reform Payments
Year Awarded:	State fiscal year 2002-03
Category of Finding:	Allowable Costs; Procurement and Suspension and Debarment
State Administering Departments:	Office of the Secretary of State

CRITERIA

Our review of the Election Reform Payments (ERP) program identified the following compliance requirements related to allowable costs and procurement and suspension and debarment:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), states that for costs to be allowable and charged to a federally funded program, the costs must be necessary, reasonable, allocable to that program, and authorized or not prohibited under state or local laws or regulations. In addition, OMB Circular A-87, Attachment B, sections 15.a and 15.b, defines equipment as property costing $5,000 or more. It also specifies that the State cannot directly charge general-purpose equipment, such as office furnishings, to a grant without approval in advance from the federal awarding agency. OMB Circular A-87, Attachment B, Section 4.b, also states that audit costs unrelated to the Single Audit Act are allowable as a direct cost to an award if specifically approved by the awarding agency.

The Code of Federal Regulations, Title 41, Section 105-71.137, establishes that states shall follow state law and procedures when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local governments. The State Contracting Manual, Section 2.05, states that each contract must clearly express the maximum amount to be paid, and Section 3.17.2 states that local assistance contracts should be on a cost-reimbursement basis with a ceiling specifying the maximum dollar amount payable by the agency. In addition, the California Public Contract Code, Section 10295(a), requires that contracts for specific purposes entered into by any state agency are void unless and until approved by the Department of General Services (General Services). Moreover, according to the State Contracting Manual, Section 4.04, contracts for more than $50,000 require General Services' approval.

Further, OMB Circular A-87, Attachment B, Section 8.h, states that for employees expected to work solely on a single federal award, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program. However, for employees expected to work on more than one federal award or on one federal and one nonfederal award, a distribution of their salaries and wages will be supported by personnel activity reports or equivalent documentation that meets specific standards.

The Code of Federal Regulations, Title 41, Section 105-71.135, requires that the State neither make an award nor permit an award (subgrant or contract) to any party that is suspended, debarred, or otherwise excluded from participation in federal programs. Further, Title 41, Section 105-68.300, states that a recipient of federal funds must verify that its vendors and subrecipients are not excluded or disqualified. The State may accomplish this verification by checking the Excluded Parties List System (EPLS) maintained by the U.S. General Services Administration, collecting a certification from each vendor and subrecipient, or adding a clause or condition to the covered transaction with each vendor and subrecipient.

CONDITION

Although the Office of the Secretary of State (office) took steps to improve its administration of ERP funds during fiscal year 2004-05, it has not corrected some of the deficiencies we reported last year. As a result, some of the same types of problems we reported last year, such as questionable procurement and contracting practices, lack of support for personal service costs, and failure to obtain suspension and debarment certifications, continue to exist. We describe these deficiencies here.

The office used ERP funds to reimburse subgrantees for general-purpose equipment costing more than $29,000 without receiving prior approval from the federal awarding agency—the Election Assistance Commission—to do so. This included items, such as a photocopier, cameras, and a computer, with acquisition costs greater than $5,000 each. Also, the office did not receive approval from the Election Assistance Commission for audit costs it paid to a private consulting firm totaling more than $48,000. Charging ERP funds for equipment and audit costs that the awarding agency has not approved puts the office at risk that the federal government may ask for the repayment of some, if not all, of these funds.

Further, the office lacked adequate controls over the ERP funds it used to reimburse eight counties for the costs of security measures they incurred during the November 2004 general election. For instance, with six of the eight counties, the office entered into either agreements or Memorandums of Understanding (MOUs), which are a type of contract, that referred to allowable costs and included provisions for reimbursement. However, the agreements and MOUs did not specify the maximum dollar amount that the office would reimburse these counties as required by the State Contracting Manual. Further, without a maximum dollar amount in the agreements and MOUs, the office had no way of knowing if they required General Services' approval. Nevertheless, during fiscal year 2004-05, none of the six counties

with agreements or MOUs received reimbursements of more than $50,000. In total, the office reimbursed these six counties more than $144,000 in fiscal year 2004-05. In addition, the office reimbursed the remaining two counties more than $873,000 without provisions for reimbursement included in their respective agreements, which consisted merely of the counties' assertions that they would comply with the office's directions. When the office does not formalize in a contract all the terms and conditions for receiving federal funds, including the maximum amount to be paid, or does not obtain required approvals when necessary, it lacks assurance that the recipients will use the funds appropriately and that the State's interests are protected adequately.

In addition, the office could not provide support for the personal service costs it charged to ERP funds for one employee during fiscal year 2004-05. Specifically, from July through November 2004, the office charged 100 percent of this employee's salary and benefits to ERP funds, and for December 2004 it charged approximately 80 percent, totaling more than $37,000. However, the office could not provide us the required timesheet nor a time certification for this employee, who estimated 80 percent of her hours were spent working on ERP-related activities. Without the required time sheets, the office cannot ensure that the employee's salary and benefits it charged to ERP funds during fiscal year 2004-05 are accurate and allowable.

Finally, the office did not take any of the measures outlined in federal regulations to ensure that the two vendors and two subrecipients we reviewed had not been suspended or debarred from participating in federal programs before awarding them ERP-funded contracts. However, we reviewed the EPLS and determined that none of the vendors or subrecipients we reviewed was suspended or debarred.

RECOMMENDATIONS

To comply with federal regulations, as well as state laws and procedures, reduce the risk that ERP funds are spent inappropriately, and increase control and protection over ERP funds, the office should take the following actions:

- Seek prior approval from the federal awarding agency for capital expenditures relating to general-purpose equipment with a cost of $5,000 or more.
- Seek approval from the federal awarding agency for any audit costs charged to ERP funds as a direct cost, other than those associated with the Single Audit Act.
- Require that contracts, MOUs, and agreements have all necessary elements, including a maximum dollar amount to be paid, and submit them to General Services for approval when required.
- Ensure that time charged to the ERP program or any other federal program is supported with appropriate documentation, including time sheets or certifications.
- Implement a process to ensure its vendors and subrecipients are not suspended or debarred from doing business with the federal government before awarding contracts.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Recommendation:

Seek prior approval from the federal awarding agency for capital expenditures relating to general-purpose equipment with a cost of $5,000 or more.

Response:

Election Assistance Commission (EAC) staff stated that the EAC would not require prior approval of voting systems procured with Help America Vote Act of 2002 (HAVA) funds to meet Title III, Section 301 voting system standards. The reasoning being that HAVA specifically provides for the use of HAVA funds to procure such equipment.

HAVA, Section 301(b), broadly defines the term "voting system" as:

- the total combination of mechanical, electromechanical, or electronic equipment (including software, firmware, and documentation required to program, control, and support the equipment) that is used to: (1) define ballots; (2) cast and count votes; (3) report or display election results; and (4) maintain and produce any audit trail information; and
- the practices and associated documentation used to: (1) identify system components and versions of such components; (2) test the system during its development and maintenance; (3) maintain records of system errors and defects; (4) determine specific system changes to be made to a system after the initial qualification of the system; and (5) make available any materials to the voter (such as notices, instructions, forms, or paper ballots).

Recommendation:

Seek approval from the federal awarding agency for any audit costs charged to ERP funds as a direct cost, other than those associated with the Single Audit Act.

Response:

The office did not seek approval from the EAC for costs it paid to a private consulting firm totaling more than $48,000 as the office contracted for professional and consultant services, not audit costs. The consultant provided services which included identifying the office's existing operational controls over programs receiving federal funds, testing of these controls, evaluating the reasonableness of our policies and procedures, and developing a corrective action plan for deficiencies in our internal control structure. These activities were not performed for the purpose of conducting an audit in accordance with Circular A-133, but were to ensure compliance with HAVA's grant administration requirements in order to comply with relevant laws, regulations, and policies. A major component of the scope of work was to develop a compliance and internal control matrix to categorize laws, regulations, and state plan elements into a spectrum identifying the degree to which operational internal controls could impact compliance. These services were necessary considering this was the office's first ever receipt of federal funds, and no employee had the required

skills/experience to perform this function. As a result of this contract work, a compliance guide documenting detailed analysis of laws and regulations was provided to the office.

Recommendation:

Require that contracts, MOUs, and agreements have all necessary elements, including a maximum dollar amount to be paid, and submit them to General Services for approval when required.

Response:

Staff, who were at the office at the time, believed that these signed agreements with the counties constituted contracts and provided the authority for funding. The office had agreed to reimburse those counties based on their written agreement to comply with the conditions, and these agreements were deemed to be contracts between the office and the counties—the same as for the other counties.

However, detailed procedures based on the law and General Services' guidelines for all contracting-related activities have been created. Our new procedures cross-reference all appropriate supporting rules, regulations, policies, and procedures including the State Administrative Manual, State Contracting Manual, California Acquisition Manual, Purchasing Authority Manual, and office policies and procedures. Moreover, controls and procedures are built into the process to ensure compliance with the applicable laws and regulations. The procedures describe the situations in which different types of procurements are appropriate and which type of procurement should be utilized under various circumstances (e.g. Request for Proposal, Invitation For Bid).

Recommendation:

Ensure that time charged to the ERP program or any other federal program is supported with appropriate documentation, including time sheets or certifications.

Response:

Time sheets have been developed for use by staff and contractors to ensure appropriate record keeping of time spent on HAVA activities. Additionally, instructions were developed for completing the time sheets and training was provided to staff.

Recommendation:

Implement a process to ensure its vendors and subrecipients are not suspended or debarred from doing business with the federal government before awarding contracts.

Response:

Beginning July 1, 2005, the office began inserting standard suspension and debarment language in contracts. The current language is as follows:

Debarment and Suspension

Pursuant to federal law, by signing this agreement or execution of this purchase order the Contractor certifies under the penalty of perjury that the contracting entity is not excluded or ineligible from federal assistance programs and thereby is not on the federal government's list of suspended or debarred entities.

Pursuant to federal law, as a component of the procurement process, the Contractor must review the federal government's list of debarred and suspended vendors and ensure no contract award is provided to a vendor on this list. This list may be viewed at www.epls.gov.

The agreements from fiscal year 2004-05 were not amended to add this language as many had been terminated or expired shortly after the initial audit findings were released. However, those which continued through fiscal year 2004-05 and into fiscal year 2005-06 were retroactively checked for their suspension and debarment status on the EPLS website and have been verified that all are free from federal debarment and/or suspension.

The office continues to implement changes to improve the program's effectiveness, achieve compliance with HAVA's mandates, and restore public confidence in the office.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Although we agree that HAVA broadly defines the term "voting system" and the EAC did not require approval of voting systems procured with these funds, we could not conclude that the items we questioned, including a photocopier, cameras, and a computer, met this broad definition. Thus, we question these payments.

Additionally, the office's statement that it did not seek approval from EAC for costs it paid to a private consulting firm totaling more than $48,000 as it contracted for professional and consultant services, not audit costs, is not completely accurate. In fact, this $798,890 contract, which the office says is for professional and consultant services specifically designates $220,850 for "internal control evaluation and compliance auditing". The office correctly points out that these activities were not performed for the purpose of conducting an audit in accordance with OMB Circular A-133. However, according to OMB Circular A-87, these non-A133 audit costs must be approved by the awarding agency to be allowable. Thus, we question them.

U.S. DEPARTMENT EDUCATION

Reference Number: 2005-2-1

Category of Finding: Allowable Costs and Cost Principles

State Administering Department: Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Title I Grants to Local Educational Agencies program (Title I, Part A) and the Migrant Education—State Grant Program (Migrant Education) identified the following requirements related to allowable costs and cost principles:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), states that for costs to be allowable and charged to a federally funded program, the costs must be necessary, reasonable, allocable to that program, and authorized or not prohibited under state or local laws or regulations. In addition, OMB Circular A-87, Attachment B, sections 8d and 8h, establish standards for the allocation of allowable fringe benefits and for the time distributions that support salaries and wages. Section 8h(4) states that for employees expected to work on more than one federal award or on one federal and one nonfederal award, a distribution of their salaries and wages will be supported by personnel activity reports or equivalent documentation that reflect an after-the-fact distribution of each employee's actual activity.

CONDITION

The Department of Education (Education) inappropriately charged a portion of two employees' salaries and fringe benefits (personal services costs) to the Title I, Part A and Migrant Education programs. Specifically, for the first employee, our review of Education's accounting records indicated that all of the employee's personal services costs were being split between the Title I, Part A and Migrant Education programs, even though this employee asserted that she spends 50 percent of her time working on a state-funded program. According to this employee, she splits her time between these two federal programs on her timesheet rather than charging her actual activity to the state-funded program because her previous manager instructed her to do so. Additionally, even though the second employee indicated that she spends her time administering two state-funded programs, Education's accounting records indicated that a portion of her time was also charged to these same federal programs. Accordingly, we estimate that $68,500 was charged inappropriately to the Title I,

Part A and the Migrant Education programs for these two employees' personal services costs during fiscal year 2004-05. Thus, Education did not ensure it complied with the federal principles for allowable costs for these personal services costs.

RECOMMENDATION

Education should ensure that it adheres to the principles and standards in OMB Circular A-87. It should ensure this by requiring these two employees to charge their time to the Title I, Part A and Migrant Education programs in a manner consistent with their actual activity.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education will advise the two employees to charge time to the appropriate funding source for the activities performed. Additionally, Education will reverse the previous charges of these two employees' time actually spent working on a state program to the appropriate funding source.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A040005; 2004

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A040005; 2004

Reference Number:	2005-3-1
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies

Federal Award Number and Calendar Year Awarded:	S010A040005; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Title I Grants to Local Educational Agencies program (Title I Part A) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds. Finally, grant requirements state that the regulations in Section 80 apply to Title I of the Elementary and Secondary Education Act of 1965 as amended.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Title I Part A subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Education disburses program funds to subrecipients based on predetermined percentages of program funds, rather than assessing and disbursing these funds based on each subrecipient's immediate cash needs. Education's lack of procedures to assess each subrecipient's cash needs, combined with its predetermined advance-payment process, does not adequately ensure that subrecipients minimize the time between receipt and disbursement of program funds.

For the 29 subrecipients we reviewed for Title I Part A funds, Education generally disbursed 80 percent, or more than $326 million, of their awards during fiscal year 2004-05 without receiving information on the subrecipients' use of funds. Moreover, according to subrecipient expenditure reports that were due to Education by January 31, 2005, our review found that 24 subrecipients reported that they carried over more than $154 million of grant funds from fiscal year 2003-04 to fiscal year 2004-05. The amounts carried over ranged from $1,805 to $146,278,446. The percentage of the amounts carried over ranged from 1.9 percent to 100 percent of the amounts Education disbursed to the 24 subrecipients in fiscal year 2003-04.

RECOMMENDATIONS

To ensure that subrecipients minimize the time between receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to reflect those needs more closely. One way Education could achieve this would be to require its subrecipients to report their program cash balances and expected costs for the upcoming payment period. Education then would advance only enough program funds to cover immediate cash needs. If Education determines that it cannot implement effective cash management procedures it should pay subrecipients on a reimbursement basis.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

With limited resources available to monitor whether subrecipients' advance payments are expended before subsequent payments are issued, Education continues to explore various options for an optimal approach on monitoring which may include seeking guidance from the United States Department of Education's Risk Management Office.

In the interim, Education continues to allocate funds proportionate to the unpaid months that have elapsed prior to and including the month of the current apportionment, based on the principle that local educational agencies (LEAs) incur federal expenditures fairly constantly through the year. Education's apportionment letters include language notifying LEAs of a potential delay in funding if significant carry over balances exist.

Reference Number:	2005-3-2
Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A040005; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the English Language Acquisition Grants program identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that English Language Acquisition Grant subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal program funds. Under its payment procedures, Education disburses 100 percent of the program funds to subrecipients without assessing each subrecipient's immediate cash needs. In addition, Education does not require its subrecipients to report any expenditure information until nine months after they receive the first of three payments. As a result of these weaknesses, Education disbursed approximately $154.9 million during fiscal year 2004-05 with no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds. Further, our review found that Education's subrecipients reported, as of October 2005, that they had carried over $88.4 million (57 percent) of $154.9 million from fiscal year 2004-05 to fiscal year 2005-06.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect each subrecipient's immediate cash needs. One way Education could achieve this would be to require its subrecipients to report their program cash balances and expected costs for the upcoming payment period. Education then would advance only enough program funds to cover immediate cash needs. If Education determines that it cannot implement effective cash management procedures, it should pay subrecipients on a reimbursement basis.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education now requires English Language Acquisition Grant recipients to report and achieve a minimum threshold of expenditures and short term encumbrances of previously released funds prior to the release of additional grant funds.

Education notified grant recipients that prior to the release of the next grant payment (the first payment of the 2005-06 award), grantees must have expended and/or have short term encumbances of at least 65 percent of their 2004-05 grant award by September 30, 2005. Short term encumbrances are defined as those encumbrances

being payable before the grant recipient's next expenditure report is due. If grantees did not meet the threshold, their next grant payment will be delayed until such time as a scheduled report identifies that this threshold has been achieved. While the introductory threshold was set at 65 percent, subsequent thresholds have been set at 80 percent.

Furthermore, Education requires three expenditure reports that will be reviewed prior to the release of additional grant funding. Therefore, following the release of the first payment of the 2005-06 award and pursuant to a grantee meeting the 65 percent threshold, all subsequent payments will be based upon expenditure reports verifying that the grantee has expended and/or has short term encumbances of at least 80 percent of all prior funding received.

Reference Number:	2005-3-3
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Numbers and Calendar Years Awarded:	S318X030005; 2003 S318X040005; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Education Technology State Grants program (Education Technology) identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Education Technology subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal program funds. Under its

payment procedures, Education disburses 85 to 90 percent of the program funds to subrecipients without assessing each subrecipient's immediate cash needs. In addition, Education generally does not require its subrecipients to report any expenditure information until more than a year after first disbursing these funds. As a result of these weaknesses, Education disbursed $67.1 million during fiscal year 2004-05 with no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds.

RECOMMENDATIONS

To minimize the time between subrecipient's receipt and disbursement of federal program funds, Education should implement procedures to assess each subrecipient's immediate cash needs and, if necessary, adjust advance payments to reflect more closely those needs. One way Education could achieve this would be to require its subrecipients to report their program cash balances and expected costs for the upcoming payment period. Education would then only advance enough program funds to cover immediate cash needs. If Education determines that it cannot implement effective cash management procedures, it should pay subrecipients on a reimbursement basis.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education Technology competitive grants are disseminated in three payments each year. The first payment of 45 percent is released after the grant award document is signed by the Superintendent or designee and returned to Education. By February 15 of each year, Education will require subrecipients to submit an expenditure report of actual expenditures to date along with the semi-annual performance report. If the subrecipient spent 50 percent or more of the first payment, the second 45 percent payment will be released. If the subrecipient spent less than 50 percent of the first payment, it will not receive a second payment until it certifies that the funds have been spent. The final payment will be released after the End-of-Period expenditure report is received by Education, and at least 50 percent of the funds from the first two payments have been spent.

Education Technology formula grants provide subrecipients advance payments to implement their approved technology plan, which may require significant puchases of hardware and software. Therefore, Education proposes to provide the subrecipients an advance payment of 50 percent of their initial grant award amount. By February 15 of each year, Education will require subrecipients to submit an expenditure report of actual expenditures to date. If the subrecipient spent 80 percent of the first payment, the second payment will be released. If the subrecipient spent less than 80 percent of the first payment, it will not receive the final payment until it certifies that the required percentage of funds have been spent. An end-of-period expenditure report that provides signed assurances that funds were expended in accordance with the grant

award documents will still be required and Education will bill for any unspent funds. It is anticipated that this process will begin with the 2006-07 grant year, depending upon completion of the web-based reporting system.

Reference Number:	2005-3-4
Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A040005A; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Improving Teacher Quality State Grants (Improving Teacher Quality) program identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that subrecipients of the Improving Teacher Quality program demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not require its subrecipients to report their use of program advances before it makes additional payments to them. As a result, Education does not ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

Of the 37 subrecipients we reviewed for the Improving Teacher Quality program, Education disbursed 80 percent of the funds without receiving information on the use

of funds. As a result, Education disbursed $27.2 million with no assurance that the subrecipients minimized the time between the receipt and disbursement of federal funds.

To assess whether Education's process resulted in excess cash balances, we compared the amount disbursed to the four largest subrecipients in fiscal year 2002-03 with the expenditures reported in their audit reports for that year, the most recent year for which readily comparable expenditure data was available. We found that while these four subrecipients reported expenditures totaling $71.6 million, Education had given them $78.2 million, or $6.6 million more than needed to cover their expenditures. This suggests that the subrecipients maintained excess cash balances.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should complete and implement planned procedures to assess subrecipients' cash needs and, if necessary, adjust advance payments to reflect more closely their immediate cash needs. One way Education could do this would be to require its subrecipeints to report their program cash balances and expected costs for the upcomming payment period, advancing only enough program funds to cover immediate cash needs. If Education determines that it cannot implement effective cash management procedures, it should pay subrecipients on a reimbursement basis.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education requires subrecipients of the Improving Teacher Quality Program to report year-to-date expenditures of previously released grant funds, which are evaluated to ensure that a minimum threshold has been achieved prior to the release of additional grant funds. During the fall 2004, carryover data from fiscal year 2003-04 was collected and used to evaluate expenditure patterns to assist in establishing the 80 percent threshold level.

Education notified all LEA subrecipients that prior to the release of fiscal year 2005-06 grant funds, an LEA must have expended and/or encumbered at least 80 percent of their available fiscal year 2004-05 grant funds. A mid-year expenditure report will also be used to determine future funding using the same 80 percent threshold.

Reference Number:	2005-3-5
Federal Catalog Number:	84.298
Federal Program Title:	State Grants for Innovative Programs

Federal Award Numbers and Calendar Years Awarded:	S298A030005; 2003 S298A040005; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the State Grants for Innovative Programs (Innovative Education), identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds. Further, sections 299.1 and 299.2 state that regulations in Section 80, with some exceptions, apply to Titles I through XII of the Elementary and Secondary Education Act of 1965 as amended.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that subrecipients of the Innovative Education program demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses 80 percent of Innovative Education program funds to subrecipients without assessing each subrecipient's immediate cash needs. As a result of this weakness, Education disbursed approximately $24.5 million during fiscal year 2004-05 with no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds.

Further, our review of 40 subrecipients who received $9.4 million during fiscal year 2003-04 from that same year's award found that 17 carried over significant cash balances to fiscal year 2004-05. The amounts that these 17 subrecipients carried over ranged from $3,700 to $5 million. The percentages carried over ranged from 79 percent to 482 percent of these amounts received. Thus, some of these carryovers included amounts received in prior years.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash

needs and, if necessary, adjust its advance payments to more closely reflect the immediate cash needs of each subrecipient. One way Education could achieve this would be to require its subrecipients to report their program cash balances and expected costs for the upcoming payment period. Education then would advance only enough program funds to cover immediate cash needs. If Education determines that it cannot implement effective cash management procedures, it should pay subrecipients on a reimbursement basis.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education implemented revisions to the Consolidated Application to capture LEA expenditure data for Innovative Education program. Education's fiscal and program offices are working together to establish a procedure to use the expenditure data prior to releasing subsequent Innovative Education funds.

Reference Number:	2005-5-1
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A030005; 2003 H126A040005; 2004
Category of Finding:	Eligibility
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) determined that the following is among the compliance requirements for eligibility:

The Code of Federal Regulations, Title 34, Section 361.41, requires the State to determine an individual's eligibility for Vocational Rehabilitation services within 60 days of receiving his or her application, with certain exceptions.

CONDITION

The Department of Rehabilitation (Rehabilitation) does not always determine applicant eligibility for Vocational Rehabilitation services within the required period. Of the

33,415 applications Rehabilitation received between July 1, 2004, and April 30, 2005, it did not determine eligibility, obtain extensions, or close cases within the 60-day period for 2,656, or 8 percent, of the applications. In fiscal years 2001-02, 2002-03, and 2003-04, Rehabilitation exceeded the 60-day period for 21 percent, 14.6 percent, and 8 percent of the applications it received, respectively. Thus, Rehabilitation made consistent improvement in recent years, but its efforts to determine eligibility promptly have leveled off.

Rehabilitation determined an applicant eligible after 60 days in 1,770 of the 33,415 applications (5.3 percent) it received between July 1, 2004, and April 30, 2005. For some of these cases, Rehabilitation obtained an agreed-upon extension after the deadline. Of those 1,770 cases, Rehabilitation was fewer than 11 days late in 60.7 percent of the cases, 11 to 30 days late in 25 percent of the cases, and 31 to 60 days late in 10 percent of the cases. It took more than 120 days to determine eligible clients in 4.3 percent of the cases. In addition, Rehabilitation still had not determined eligibility status in 291 cases as of July 12, 2005, and 595 cases had other resolutions after the 60-day deadline. When Rehabilitation does not determine an applicant's eligibility within the required period, it reduces the assurance that clients receive the required vocational rehabilitation services promptly.

RECOMMENDATION

To ensure that applicants receive Vocational Rehabilitation services promptly, Rehabilitation should improve its efforts to determine eligibility within the required period.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Rehabilitation agrees with this finding. While Rehabilitation acknowledges its efforts to improve timely eligibility determinations have leveled off for fiscal year 2004-05, there remains a strong commitment to improve in this area. By utilizing the following corrective action plan in collaboration with district administrators, rehabilitation supervisors, counselors and cooperative program partners, Rehabilitation expects its compliance with this federal requirement to improve in fiscal year 2005-06.

1. SHARE INFORMATION WITH DISTRICT ADMINISTRATORS

Best practices for timely eligibility determinations continue to be identified and shared in regional district administrators' meetings. In addition, statewide meetings are being scheduled in fiscal year 2005-06 for the district administrators to design a mechanism for effective dissemination of these and other best practices in Rehabilitation.

The district administrators continue to receive reports that track the number of overdue eligibility determinations for each counselor on a monthly basis. These reports are distributed to Rehabilitation supervisors and counselors for prompt and immediate follow-up.

2. INFORM AND EDUCATE REHABILITATION STAFF

The importance of timely eligibility determination continues to be stressed in all Rehabilitation sponsored training courses and during staff meetings. The Case Recording Handbook, Chapter 2, also provides a full description of the presumptive eligibility provisions in the Code of Federal Regulations. Counselors are continually being trained to utilize existing information and the presumptive eligibility criteria as opposed to requiring additional medical/vocational assessments prior to determining eligibility, which historically has delayed timely eligibility determination. Counselors and Rehabilitation supervisors continue to receive automated reminder notices on the Field Computer System before the expiration of the 60 days allowed for eligibility determination. Memorandums containing further guidance on conducting and tracking timely eligibility determinations will be developed and issued to field staff.

3. LOCAL LEVEL MONITORING OF ELIGIBILITY DETERMINATIONS

The Rehabilitation supervisors continue to conduct reviews of eligibility determinations and extensions to ensure appropriateness and compliance with federal regulations. These supervisors work with the counselors to utilize existing information to the maximum extent possible and the presumptive eligibility criteria to ensure more timely eligibility determinations. Counselors and Rehabilitation supervisors continue to receive automated reminder notices on the "Reminder/Approval lists" before the expiration of the 60 days allowed for eligibility determination. In addition to the automated reminder notices, reports are generated monthly to track the number of overdue eligibility determinations in each district. These reports have been modified to include information as to whether the consumer receives Supplemental Security Income or Social Security Disability Income to alert counselors to utilize the presumptive eligibility criteria and subsequently expedite the eligibility determination process.

4. *EXECUTIVE LEVEL MONITORING OF ELIGIBILITY DETERMINATIONS*

On a monthly basis, the deputy directors review regional and district overdue eligibility reports and the Consumer Satisfaction Surveys to identify trends of overdue eligibility determinations and then work with the district administrators to resolve the issues preventing the timely determination of eligibility. The district administrators have begun reporting their strategies to improve the timeliness of eligibility determinations as part of their annual strategic plans submitted to the deputy directors.

5. PROVIDE GUIDANCE AND MONITORING TO COOPERATIVE PROGRAM PARTNERS

Cooperative contract renewal training is provided annually to each district and their partner agency contract administrators. This training supports the requirement that the referral and application process for all cooperative programs be delineated in each

contract. Auditing eligibility documentation is a component that has been incorporated in the cooperative program review protocol to ensure the district and their partners observe their respective responsibilities in achieving timely eligibility determination for program applicants.

Reference Number:	2005-7-1
Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A020116; 2002 H027A030116; 2003
Category of Finding:	Level of Effort—Maintenance of Effort
State Administering Department:	Department of Education

CRITERIA

Our review of the Special Education—Grants to States program (Special Education) identified the following requirements related to level of effort—maintenance of effort:

The United States Code, Title 20, Section 1412(a)(19)(A), prohibits any state that receives assistance under Special Education from reducing the amount of state financial support for Special Education and related services for children with disabilities, including support for the excess costs of educating those children, to less than the amount of that support for the preceding fiscal year. Further, the Code of Federal Regulations, Title 34, Section 300.154(a), specifies that the State must have on file with the U.S. Department of Education (USDE) information to demonstrate that the State will comply with this requirement.

CONDITION

In response to our fiscal year 2003-04 recommendations, the Department of Education (Education) implemented a system for monitoring its compliance with the maintenance of effort requirement; however, it did not clarify with USDE which funds should be included in its maintenance of effort determination. Thus, we cannot conclude that it has met this requirement.

To demonstrate its compliance with the maintenance of effort requirement for fiscal year 2002-03, the most recent year for which complete information is available, Education chose to include only those expenditures authorized under certain General Fund appropriations specific to Education and certain special education programs.

Using this method, Education determined that it had met its maintenance of effort requirement for fiscal year 2002-03. Although we found that the expenditure information Education compiled is materially accurate, we cannot conclude that Education has included all of the information it should to demonstrate the State's compliance with the maintenance of effort requirement. For example, Education did not include special education expenses incurred by other State departments, such as Mental Health. As we reported last year, the State's deferral of $100 million from Mental Health's fiscal year 2002-03 budget, some of which in the prior year Mental Health had used to provide services to children in Special Education, caused some to question whether the State had met its maintenance of effort requirement for fiscal year 2002-03.

Absent an agreement with USDE, neither we nor Education can be sure what should be included in its maintenance of effort determination. Because failure to meet this requirement could result in the State losing some federal funding for Special Education, it is important that Education obtain such an agreement with USDE.

RECOMMENDATION

Education should obtain the USDE's agreement as to what should be included and excluded from the State's maintenance of effort calculation for special education.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education will seek guidance from the USDE officials as requested.

Reference Number:	2005-7-2
Federal Catalog Number:	84.298
Federal Program Title:	State Grants for Innovative Programs
Federal Award Number and Calendar Year Awarded:	S298A020005; 2002
Category of Finding:	Level of Effort—Supplement Not Supplant
State Administering Department:	Department of Education

CRITERIA

Our review of the State Grants for Innovative Programs (Innovative Education) identified the following requirement related to level of effort:

The United States Code, Title 20, Section 7217(c) provides that funds made available under this program shall be used to supplement, and not supplant, any other federal, state, or local education funds.

CONDITION

The Department of Education (Education) does not have a system in place for monitoring the State's compliance with the requirement that it use revenues from Innovative Education to supplement, rather than supplant, existing funds for grant-related activities. By not tracking whether it is using its federal funds to supplement existing funds, the State may not identify potential noncompliance in time to take the necessary corrective action, which ultimately could result in reduced federal funding. We independently performed procedures to determine whether Education met the supplement-not-supplant requirement for Innnovative Education. The State appears to have met these requirements.

RECOMMENDATION

Education should implement a process to monitor whether the revenues from Innovative Education supplement other funding for grant-related activities.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education continues to develop a process to determine whether the federal grant revenues supplement, rather than supplant, other funding for the Innovative Education program.

Reference Number:	2005-8-3
Category of Finding:	Period of Availability
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Adult Education—State Grant Program (Adult Education), the Twenty-First Century Community Learning Centers Grant program (Twenty-First Century), and the Reading First State Grants program (Reading First) identified the following requirements relating to period of availability:

The Code of Federal Regulations, Title 34, Section 80.23(b), requires the State to liquidate all obligations incurred under an award no later than 90 days after the end of the funding period. In addition, according to guidance issued by the U.S. Department of Education, states must obtain a waiver permitting the late liquidation of grant obligations beyond this 90-day period.

CONDITION

The Department of Education (Education) did not obtain the U.S. Department of Education's approval to liquidate obligations beyond the 90-day liquidation period for three of its grant awards. Although the liquidation period for these grant awards expired December 31, 2004, Education liquidated obligations totaling $300,000 for its Reading First program and $200,500 for its Twenty-First Century program in February 2005. Further, Education liquidated obligations totaling $117,000 for its Adult Education program in March 2005. These disbursements took place more than one month and as many as three months after the 90-day liquidation period for these awards had expired. There was no U.S. Department of Education approval to do so. By failing to obtain the U.S. Department of Education's approval to liquidate these obligations after the 90-day period, Education risks having to return funds to the federal awarding agency.

RECOMMENDATION

Education should ensure that it obtains the U.S. Department of Education's approval to liquidate obligations beyond the 90-day period.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

For the Reading First program claim, the funds were drawn within the liquidation period; therefore, Education did not need to contact the U.S. Department of Education (ED) for an extension. However, the claim could have been processed in a more timely fashion. Education recently contacted the ED and realized that it may have kept the funds in the Grants Administration and Payment System (GAPS) until the claim was ready to be drawn, and then contacted the ED for a liquidation extension. Education will implement this process effective immediately.

For the Adult Education and Twenty-First Century program claims, the first-in, first-out process was used to fully expend the 2002 federal grants. According to the Policy Memorandum issued by the ED, titled "Extension of Liquidation Periods and Related

Accounting Adjustments for Grantees under Department of Education State-Administered Programs", ED will consider requests for late liquidations and if approved, will open GAPS. Since Education did not need to access GAPS because the grant balances were zero, Education did not contact ED for an extension. In the future, if late liquidations are submitted, Education will contact ED for approval before completing the last-in, first-out process.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.002
Federal Program Title:	Adult Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	V002A020005; 2002

Federal Catalog Number:	84.287
Federal Program Title:	Twenty-First Century Community Learning Centers Grant
Federal Award Number and Calendar Year Awarded:	S287C020005; 2002

Federal Catalog Number:	84.357
Federal Program Title:	Reading First State Grants
Federal Award Number and Calendar Year Awarded:	S357A020005; 2002

Reference Number:	2005-14-1
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A040005; 2004
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Education

CRITERIA

Our review of the Migrant Education—State Grant Program (Migrant Education) determined that the following compliance requirement related to the subgrant process:

The United States Code, Title 20, Section 6394(b)(5), requires the State to determine the amount of subgrants it awards to local educational agencies (LEAs) and to take into account the numbers and needs of migrant children, the priority for services for certain migrant children, and the availability of funds from other federal, state, and local programs.

CONDITION

The Department of Education (Education) did not take into account all the required information when it awarded subgrants to LEAs for Migrant Education. During fiscal year 2004-05, Education allocated funds to LEAs using current data on the numbers and needs of migrant children in the State. Although Education uses its applications to obtain limited information about the availability of funds from other programs, it did not consider even limited information when it determined the amount of subgrants it awarded to LEAs. In addition, Education did not obtain information to allow it to take into account the priority for services for certain migrant children in the State when it determined the subgrant amounts awarded to LEAs. As a result, Education cannot be sure it funded the LEAs appropriately when it determined the subgrants for Migrant Education.

RECOMMENDATION

Education should ensure that it obtains sufficient information about the availability of funds from other programs and the priority of services and takes the information into account when it determines the size of subgrants to LEAs for Migrant Education.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education developed a revised sub grant formula process that includes the following criteria:

1. Counts of eligible migrant students
2. Counts of eligible migrant students who moved within one year
3. Counts of eligible migrant students ages 19-21
4. Academic need
5. Priority for services
6. Availability of other state and federal funds

Each of these criteria is in place for the sub grant funding process with the exception of the priority for services. This factor requires extracting and matching data from two separate databases (Migrant Student Information System (MSIN) and CDE-STAR) to

determine the counts of priority for service students for each grantee. Education is addressing privacy and other legal requirements before making student level state assessment data available to the MSIN.

If the priority for services data access issues are resolved, Education should be able to implement the revised sub grant formula process beginning with the fiscal year 2006-07.

Reference Number:	2005-14-3
Federal Catalog Number:	84.032
Federal Program Title:	Federal Family Education Loans
Year Awarded:	State fiscal year 2004-05
Category of Finding:	Special Tests and Provisions
State Administering Department:	California Student Aid Commission

CRITERIA

Our review of the Federal Family Education Loans program (loan program) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 34, Section 682.414, requires guaranty agencies, such as the California Student Aid Commission (Student Aid), to maintain current, complete, and accurate records for each loan they hold. Good internal controls over information systems would include strong general controls, which are the structure, policies, and procedures that apply to an entity's overall computer operations. Some of the major categories of general controls are entitywide security program planning and management, and access controls.

Further, the California Education Code, Section 69522, authorized Student Aid to establish a nonprofit auxiliary organization to administer activities associated with the loan program. This section also requires the operations of the auxiliary organization to be conducted in conformity with an operating agreement approved annually by Student Aid and requires Student Aid to oversee the operations of the auxiliary organization.

CONDITION

Student Aid's auxiliary organization administers the loan program. However, the auxiliary organization has not developed adequate internal controls over its

information systems to provide reasonable assurance that it keeps current, complete, and accurate records of each loan. Specifically, we found weaknesses in the auxiliary organization's controls over entitywide security planning and management, and restriction of access to computer software and data files. We also found weaknesses in the operating agreement between Student Aid and its auxiliary organization. These weaknesses hamper Student Aid's ability to ensure that the auxiliary organization maintains strong controls over its information systems.

The auxiliary organization's management has not provided sufficient entitywide security planning and management. We found that although the auxiliary organization has made some progress by hiring a contractor that completed a security risk assessment in June 2005, as of September 2005 it had yet to complete an entitywide security program plan. This plan should clearly describe the auxiliary organization's security program and the policies and procedures that support it. In addition, the plan should cover all major facilities and systems and outline the duties of the security management function. The lack of planning and management has the potential to result in insufficient protection of sensitive or critical computer records.

The auxiliary organization also needs to strengthen its logical security controls. Logical security controls are the policies and electronic access controls designed to restrict access to computer software and data files. Although the auxiliary organization has made some changes it continued to have the following weaknesses in controls over its software and data files during fiscal year 2004-05:

- It did not always promptly remove employees' electronic access when they leave the employ of the auxiliary organization. We tested a sample of 22 employees who had left the employ of the auxiliary organization and found that in three cases the auxiliary organization did not promptly remove the employees' electronic access. For these employees, the auxiliary organization took 2, 3, and 5 days to remove access after the employees left the employ of the auxiliary organization.

- A limited number of employees are allowed access to data that is not related to their assigned responsibilities. Additionally, the auxiliary organization inappropriately allowed these same employees to make changes to sensitive data, even though the changes were not subject to the normal edits of its information system. Further, the auxiliary organization did not maintain a complete history or audit trail of the changes made to the data.

Finally, Student Aid's operating agreement with the auxiliary organization does not include provisions to ensure that the auxiliary organization maintains strong controls over its information systems. For fiscal years 2002-03 and 2003-04, we noted that the operating agreement did not detail Student Aid's expectations for the operation of the information technology system that maintains the records for the loan program. Such expectations could include requirements for information security, the performance of a security risk assessment, and development of an information security program plan. We also noted that Student Aid could require its auxiliary organization to obtain an audit of its information technology controls that are relevant to Student Aid's financial statements. This audit should report on whether such controls were suitably designed

to achieve specified control objectives, whether they have been enacted as of a specific date, and whether the controls were sufficient to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Student Aid extended the operating agreement for fiscal year 2004-05 without adding significant provisions to strengthen controls over information systems.

RECOMMENDATIONS

Student Aid's auxiliary organization should implement an entitywide program for security planning and management that provides for strong physical and logical security controls over its information systems. This will help ensure that it maintains current, complete, and accurate records for each loan that it holds. In addition, Student Aid should amend its operating agreement with its auxiliary organization to specify its expectations related to the control structure over the information system.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Entity-wide Security Program Plan

During federal fiscal year 2005-06, the auxiliary's Information Security Officer developed an entity-wide security program plan that defines the information security initiatives planned for execution during the three years ending September 30, 2008. This plan was developed using the recommendations from the risk assessment performed in the prior year.

Removal of Employee Electronic Access

The Internal Audit division will review the three instances identified by the auditor to determine if existing procedures are being followed and/or whether additional controls are necessary to help ensure prompt removal of access for terminated employees.

Data Maintenance

During fiscal year 2005-06, the auxiliary performed an inventory of the key data maintenance changes currently performed, determined the cause(s) and criticality of such changes as well as the volume and associated risk(s) of such changes. The auxiliary determined that for certain updates that are currently performed using data maintenance; modifications could be made to its information system which would provide a systematic process for performing these updates including the creation of an automated audit trail. A project to implement these enhancements will be developed and provided to executive management for consideration.

A process has also been implemented to address updates/actions that the auxiliary determined could not be performed through a systematic process and therefore will continue to be performed through data maintenance. Specifically, the auxiliary has created a centralized log that documents all types of data maintenance updates that are currently occurring or requested. Information documented in the log includes a

description of the type of data change, impact to the business unit or borrower if the error is not corrected, and the action taken. The Technology Solutions and Services Division is also responsible for reviewing the requests to ensure that there is no systematic means to perform the change.

The two divisions that currently perform data maintenance updates have both developed formal procedures for requesting, authorizing and performing data maintenance changes. Additionally, the Internal Audit division is scheduled to perform a review of these newly implemented data maintenance processes during the two-year internal audit cycle ending September 30, 2007.

Operating Agreement

Commission management agrees with the need for stronger provisions in the Operating Agreement to appropriately enforce the auxiliary to maintain strong control over its information systems and will continue to suggest revisions to the Commission in support of the auditor's recommendation, when the Operating Agreement is next updated.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number:	2005-1-1
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0405CA5028; 2004 05-0505CA5028; 2005
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to activities allowed:

The Code of Federal Regulations, Title 42, Section 447.50 allows the State to impose cost-sharing charges on some of its Medicaid recipients. The California Code of Regulations, Title 22, sections 50090 and 50653(a) defines share of cost as a person's or family's net income in excess of their maintenance need that must be paid or obligated toward the cost of health care services each month.

The Code of Federal Regulations, Title 42, Section 447.253(i) requires the Medicaid agency to pay for inpatient hospital and long-term care services using rates determined in accordance with methods and standards specified in an approved state plan.

CONDITION

The Department of Health Services (Health Services) does not always ensure that its fiscal intermediary pays Medicaid claims correctly. Specifically, we found the following errors during our testing of 30 claims processed by its fiscal intermediary.

- Because of a problem in an automated system, Health Services overpaid a provider $53 for one pharmacy claim we reviewed. Providers submit most of their pharmacy claims for Medicaid reimbursement through the automated point of service system (CALPOS). Using the claim information, CALPOS computes the amount that Medicaid will pay. However, because of a system problem that the fiscal intermediary said began in January 2000, CALPOS did not deduct the Medicaid recipient's share of costs from certain claims, causing the Medicaid payment to be overstated. The fiscal intermediary, which maintains CALPOS,

indicated it corrected the problem in September 2005. However, at the completion of our fieldwork, Health Services had not yet determined the extent of overpayments that resulted from this problem.

- For a second claim, Health Services underpaid one inpatient care provider $464 because its fiscal intermediary had not updated this provider's hospital stay rate in its system. The fiscal intermediary had not updated the rate of $230.29 per day, effective in August 2000, for this provider. It should have changed the rate to $236.82 per day, which was in effect between August 2003 and July 2005. Although Health Services is responsible for ensuring that its fiscal intermediary updates rates for hospitals, it did not know whether its fiscal intermediary has done so consistently.

RECOMMENDATIONS

Health Services should determine the extent of the overpayments it may have made as a result of the system problem, and recover any overpayments. Health Services also should ensure that its fiscal intermediary consistently updates the hospital stay rates used to calculate amounts paid to hospitals. When warranted, it should adjust the inaccurate payments that have occurred.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees that a system problem resulted in an overpayment of some pharmacy claims. As noted in the audit finding, the system problem was corrected in September 2005 to ensure share of cost is deducted from the claim regardless of whether the provider included that information on the claim or not. Health Services is taking action to determine the extent of any other potential overpayments that may have occurred as a result of the system problem and to recover all overpayments. An Erroneous Payment Correction (EPC) plan has been initiated to identify any other pharmacy claims that may have been impacted by the system problem and to recoup any overpayments.

Health Services agrees that the system problem resulted in an underpayment on an inpatient care claim. Health Services is taking action to determine the extent of any other potential underpayments that may have occurred as a result of the system problem and to resolve all underpayments. The coordination of rates function has been reassigned to the Payment Systems Division's Fiscal Intermediary Information Technology Management (FIITM) Branch and the fiscal intermediary, Electronic Data Systems (EDS). This arrangement more closely aligns the facilitation of the system change to the branch responsible for other systems modifications. The FIITM Branch is working with the Medi-Cal Policy Division, Provider Enrollment Branch, and EDS to identify all adjudicated claims that were reimbursed at the incorrect rate and generate EPC's to compensate the provider or department (if appropriate) for the difference between the rate paid and the proper rate that should have been applied at the time the services were rendered.

Reference Number:	2005-2-4
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention— Investigations and Technical Assistance[2]
Federal Award Numbers and Calendar Years Awarded:	U90/CCU917016-05; 2004 U90/CCU917016-04; 2003
Category of Finding:	Allowable Costs
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Public Health Preparedness and Response for Bioterrorism (Bioterrorism) program identified the following compliance requirements related to allowable costs:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), Attachment B, Section 8.h, states that if employees are expected to work solely on a single federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that they worked solely on that one program. To assist programs in meeting the federal regulations, the Department of Health Services (Health Services) established form DHS 2361, Federal Certification of Activity, and established specific procedures requiring employees who work solely on a single federal award or cost objective to complete the form twice during a year. Health Services' procedures require that program staff maintain employee certifications in the program offices.

CONDITION

Health Services did not ensure that employees who worked full-time on the Bioterrorism program consistently completed the required certifications. Specifically, our review of a sample of four areas within Health Services that asserted their employees worked full-time on the Bioterrorism program found that three did not obtain the required certifications from their employees. Health Services charged personal services costs totaling $3.8 million to the Bioterrorism program during fiscal year 2004-05 for the employees in these three areas. This amount represented 59 percent of the total personal services costs charged to the Bioterrorism program. One of the three areas has stated that it is instituting the certification process. Without

[2] This finding relates to the Public Health Preparedness and Response for Bioterrorism program portion of this federal program.

the certifications required by federal regulations, Health Services cannot ensure that the personal services costs charged to the Bioterrorism program during fiscal year 2004-05 are allowable.

RECOMMENDATION

Health Services should ensure that the employees working full time on the Bioterrorism program consistently complete the required certification.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees with the finding and will institute procedures immediately to ensure that all Health Services' employees holding positions funded under the Centers for Disease Control and Prevention Cooperative Agreement complete the required certification twice during each year. Health Services' procedures will require that program staff maintain employee certifications in the program offices.

Reference Number:	2005-3-6
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention—Investigations and Technical Assistance[3]
Federal Award Numbers and Calendar Years Awarded:	U90/CCU917016-05; 2004 U90/CCU917016-04; 2003 U90/CCU917016-03; 2002
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Public Health Preparedness and Response for Bioterrorism program identified the following requirements related to cash management:

The Code of Federal Regulations, Title 45, Section 92.21, allows a state's subrecipients to receive advance payments provided they maintain or demonstrate the

[3] This finding relates to the Public Health Preparedness and Response for Bioterrorism program portion of this federal program.

willingness and ability to maintain procedures to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 92.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

California Health and Safety Code, sections 101317(d)(1) and (2), requires the Department of Health Services (Health Services) to disburse funds quarterly to local health jurisdictions (subrecipients) for the Public Health Preparedness and Response to Bioterrorism program contingent upon completion of certain tasks.

CONDITION

Health Services does not ensure that the Public Health Preparedness and Response for Bioterrorism program's subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal program funds. According to the chief of Health Services' Program Support Section, Emergency Preparedness Office, Health Services follows California Health and Safety Codes and disburses the first quarterly payment to its subrecipients upon receipt of their applications. It disburses subsequent payments contingent upon the approval of a subrecipient's plan and budget and progress in implementing that plan, as well as submission of fiscal reports. However, before disbursing these additional payments, Health Services does not assess its subrecipients' cash needs and adjust the advance payments accordingly. As a result of these weaknesses, Health Services disbursed approximately $61 million during fiscal year 2004-05 with no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds. Further, Health Services' records indicate subrecipients reported that they had unspent funds for fiscal year 2004-05 totaling more than $5.8 million.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Health Services should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its quarterly advance payments to reflect more closely those needs. One way Health Services could achieve this would be to require its subrecipients to report their program cash balances and expected costs for the upcoming payment period. Health Services then would advance only enough program funds to cover immediate cash needs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services disagrees with the audit findings. The Bureau of State Audits' (BSA) recommendation is that Health Services implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its quarterly advance payments to more closely reflect each subrecipient's immediate cash needs. The BSA bases this

recommendation upon and cites the Code of Federal Regulations, Title 45, Section 92.21, one of the Department of Health and Human Services (HHS) regulations for the uniform administration of grants to States and local governments, but does not take into account the Code of Federal Regulations, Title 45, Section 92.37, or State statute pertaining to federal bioterrorism grants. Section 92.21, which relates to payments, embraces the principal that methods and procedures for payment shall minimize the time elapsing between the transfer of funds and disbursement by the grantee or subgrantee. Specifically with respect to advances, the regulation provides that grantees and subgrantees shall be paid in advance, provided they maintain or demonstrate the willingness and ability to maintain procedures to minimize the time elapsing between the transfer of the funds and their disbursement by the grantee or subgrantee.

Section 92.21 is not, however, the only regulation governing the distribution of HHS money by States. Section 92.37, pertaining to subgrants, requires in subsection (a) that States follow state law and procedures when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local governments. (See text below.) This section appears to require that Health Services follow state law in this instance.

State law pertaining to bioterrorism preparedness grants specifically provides that "funds appropriated pursuant to the annual Budget Act or some other act for allocation to local health jurisdictions . . . shall be disbursed quarterly to local health jurisdictions" [Health & Safety Code, 101317(d)]. The first quarterly payment is paid upon submission of an application [Health & Safety Code, 101317(d)(1)]. Health Services is directed to "develop a streamlined process for continuation of funding that will . . . assure the continuity of local plan activities" [Health & Safety Code, 101317(d)(1)].

Payments beyond the first quarter are contingent upon approval by Health Services of the local health jurisdiction's plan and the local health jurisdiction's progress in implementing the provisions of the local health jurisdiction's plan, as determined by Health Services. The subsequent payments are not predicated upon the local health jurisdiction's cash flow needs [Health & Safety Code, 101317(d)(2)].

Health Services is authorized to "withhold quarterly payments" if the local health jurisdiction is not in compliance with this article or the terms of that local health jurisdiction's plan [Health & Safety Code, 101317(i)]. This does not appear to authorize Health Services to partially withhold payments, on the basis of perceived need, or for any other reason. Rather, Health Services may only withhold the "quarterly payment" until the local health jurisdiction comes into compliance.

In effect, if Health Services were to follow BSA's recommendation, Health Services would be making partial quarterly payments on the basis of perceived cash needs, not full quarterly payments based on progress as required by state law.

Health Services provides on-going monitoring and technical assistance of local health jurisdictions. For example, each local health jurisdiction is assigned a Health Services project officer who provides technical assistance, monitoring and oversight on an ongoing basis. Health Services issues guidance each year to local health jurisdictions

on the use of federal bioterrorism grant funds. Local health jurisdictions are required to sign an agreement with Health Services and submit a work plan and budget for their allocated bioterrorism funds from the Centers for Disease Control and Prevention and Health Resources and Services Administration. Health Services reviews and approves the work plans and budgets. Annually, Health Services requires each local health jurisdiction to submit two progress reports which include a narrative report and a fiscal report of expenditures; Health Services analyzes the submitted information in order to assess local performance including use of bioterrorism grant funds.

It should be noted that the regulation cited by BSA expresses a preference for advances (it states that the money shall be advanced), and that quarterly advance payments based on progress can have the effect of minimizing the time elapsed between the transfer of funds and disbursement. Thus it cannot be said that the approach provided by statute is inconsistent with the Code of Federal Regulations, Title 45, Section 92.21.

It should also be noted that HHS has been making grant payments to Health Services for several years, with presumably full knowledge of the provisions of Health and Safety Code 101317 for quarterly payments. No objections have been raised by HHS to the requirements in state law. If HHS felt that the quarterly payments required by state law was inconsistent with its principal that methods and procedures for payment shall minimize the time elapsing between the transfer of funds and disbursement by the grantee or subgrantee, it could have threatened the state's funding unless the statute were changed. It has not done so.

Code of Federal Regulations, Title 45, Section 92.37(a) *States*. States shall follow state law and procedures when awarding and administering subgrants (whether on a cost reimbursement or fixed amount basis) of financial assistance to local and Indian tribal governments. States shall:

(1) Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations;
(2) Ensure that subgrantees are aware of requirements imposed upon them by Federal statute and regulation;
(3) Ensure that a provision for compliance with Section 92.42 is placed in every cost reimbursement subgrant; and
(4) Conform any advances of grant funds to subgrantees substantially to the same standards of timing and amount that apply to cash advances by Federal agencies.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

According to our Legal Counsel, the California Health and Safety Code, Section 101317(d)(1) does not preclude Health Services from assessing its subrecipients' cash needs and adjusting the quarterly payments, when necessary to comply with federal regulations. However, if Health Services believes state law requires it to make quarterly payments without regard to the federal regulations pertaining to cash management, it should seek clarification from the U.S. Department of Health and Human Services.

Reference Number:	2005-5-2
Federal Catalog Number:	93.044
Federal Program Title:	Special Programs for the Aging—Title III, Part B—Grants for Supportive Services
and	Senior Centers
Federal Award Numbers and Calendar Years Awarded:	04AACAT3SP; 2003 05AACAT3SP; 2004
Category of Finding:	Eligibility
State Administering Department:	Department of Aging

CRITERIA

Our review of the Special Programs for the Aging—Title III, Part B—Grants for Supportive Services and Senior Centers identified the following compliance requirement related to eligibility:

The United States Code, Title 42, Section 3026(a)(8)(C), states that case management services will be provided by a public agency or a nonprofit private agency.

CONDITION

The Department of Aging (Aging) does not have adequate procedures to ensure that case management providers are public or nonprofit private agencies. Specifically, Aging did not screen case management providers for public or nonprofit status during fiscal year 2004-05. As a result, Aging may not have complied with federal requirements for eligibility. For the eight Area Agencies on Aging we reviewed, we performed procedures to verify that their case management providers were public agencies or nonprofit private agencies.

In response to a similar finding we reported during our fiscal year 2003-04 audit, Aging stated that it would modify contracts to include federal requirements for eligibility, and integrate these requirements into its monitoring process. Although Aging received our finding too late to modify its fiscal year 2004-05 contracts, we noted that it did modify its fiscal year 2005-06 contracts to include such requirements and in March of 2005 it also integrated federal eligibility requirements into its monitoring process.

RECOMMENDATION

Aging should continue to ensure that it complies with its new procedures to screen case management providers for their public or nonprofit private status.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Aging concurs with this finding. As stated above, Aging has already modified contracts for 2005-06 adding requirements that case management providers be public or nonprofit private agencies as required in United States Code, Title 42, Section 3026(a)(8)(C).

Reference Number:	2005-5-3
Federal Catalog Number:	93.767
Federal Program Title:	State Children's Insurance Program
Federal Award Numbers and Calendar Years Awarded:	05-02A5CA5021; 2002 05-03A5CA5021; 2003
Category of Finding:	Eligibility
State Administering Department:	Managed Risk Medical Insurance Board

CRITERIA

Our review of the State Children's Insurance Program identified the following compliance requirements related to eligibility:

The Centers for Medicare and Medicaid Services sets broad federal guidelines for the State Children's Insurance Program but allows states to determine the design of the program, eligible groups, benefit packages, payment levels for coverage, and administrative and operating procedures. The Managed Risk Medical Insurance Board's (Insurance Board) state plan includes a description of eligibility standards and a methodology for making eligiblity determinations. The Insurance Board establishes regulations that specify the detailed requirements for determining eligibility. Specifically, the California Code of Regulations, Title 10, Section 2699.6607, requires the program to verify that any person for whom an application is being made meets eligibility requirements, including citizenship, age, and income.

CONDITION

Although the Insurance Board delegates the day-to-day eligibility and enrollment operation for the State Children's Insurance Program to a contractor, it does not always ensure that its contractor maintains critical documentation to support eligibility determinations. Specifically, for two of 42 participants in the State Children's Insurance Program we reviewed, we were unable to verify that they met eligibility requirements for age and citizenship because the Insurance Board's contractor could not provide documentation to support the eligibility determination. Further, the Insurance Board's contractor incorrectly determined that a third participant was eligible for the State Children's Insurance Program because it used the family's net income instead of gross income when determining whether the family met the income requirements for this program. When the Insurance Board does not ensure that its contractor is maintaining critical documentation to support eligibility determinations, it cannot monitor that its contractor is enrolling only applicants who are eligible for the State Children's Insurance Program.

RECOMMENDATIONS

The Insurance Board should ensure that its contractor maintains the critical documentation necessary to demonstrate that participants enrolled in the State Children's Insurance Program are eligible and that its contractor obtains any documentation that is missing from its files. Further, the Insurance Board should ensure that its contractor removes from the program the participant who did not meet income eligibility requirements.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Insurance Board agrees with the Bureau of State Audits' (BSA) findings. The Insurance Board acknowledges that MAXIMUS, the Insurance Board's eligibility and enrollment contractor could not locate, for two of 42 children, citizenship documentation required in the initial eligibility determination process. Although the documentation could not be located, the Insurance Board assures that procedures are in place to assure that the documentation on citizenship or legal alien status is used in the eligibility and enrollment process. Under Healthy Families Program (HFP) regulations, had the documentation not been provided within two months of enrollment, then, the children would have been disenrolled. However, during the Annual Eligibility Review (AER) process, the children were determined to be income eligible and therefore maintained ongoing enrollment in the HFP. According to HFP Regulations, Section 2699.6625, children are not required to re-submit their citizenship documentation. The Insurance Board ensures that its vendor, MAXIMUS, maintains standards and methodologies (i.e. quality controls and system logics) for making accurate eligibility determinations and maintains critical documentation to support these determinations.

MAXIMUS currently has a system in place ensuring that, as soon as any document is received from an applicant, it is immediately scanned into the system and linked to the appropriate Family Member Number. This system ensures that images for relevant documents are captured and stored in the system. However, prior to January 1, 2004, the Insurance Board had a different administrative vendor, EDS. EDS followed the same regulations for disenrolling children without citizenship or legal alien documentation. During the transition of the administrative vendor contract, from EDS to MAXIMUS, not all correspondence that was received from applicants was forwarded to MAXIMUS for system conversion. This was one of the challenges during the transition to the new administrative vendor. The Insurance Board made the business decision based on a cost benefit analysis, to limit the conversion of documents mainly to HFP applications and AER forms. Thus, any documents classified as "correspondence" were not converted. For example, if an original application did not include a birth certificate, the applicant would be asked to submit the document. Once this document was received it would have been classified as a "correspondence" and therefore not necessarily converted over to MAXIMUS. The citizenship documentation for the two children were likely received as "correspondence" during the time in which EDS was the administrative vendor.

The Insurance Board also concurs with the findings that a child was incorrectly enrolled because the vendor used the family's net income rather than the gross income when making the eligibility determination. In this case, the proof of income was not a typical paycheck stub that most individuals provide. In most cases, the documentation provided to the HFP clearly identifies the gross amount paid. The paycheck stub used in this case was for a military service employee. This type of paycheck stub was unique and did not clearly identify the gross paid amount, which resulted in the income being incorrectly entered into the system. MAXIMUS explicitly instructs staff to use the "gross" amount identified on the paycheck stub during the key data entry process. However, this was a particularly unusual paycheck stub and the processing error does not reflect a lack of system control processes in place or the vendor's lack of knowledge about the HFP requirements.

The BSA recommends that the Insurance Board disenroll the child whose family did not originally meet the income requirements for this program. However, the Insurance Board will not disenroll the child from the HFP because during the subsequent 2005 AER process, the child was correctly determined to be income-eligible for the program and continues to be enrolled in HFP. Another eligibility determination will occur for this child during the 2006 AER process.

Reference Number:	2005-8-1
Federal Catalog Number:	93.569
Federal Program Title:	Community Services Block Grant

Federal Award Number and Calendar Year Awarded:	G-03B1CACOSR; 2003
Category of Finding:	Period of Availability
State Administering Department:	Department of Community Services and Development

CRITERIA

Our review of the Community Services Block Grant identified the following compliance requirement relating to period of availability:

The Code of Federal Regulations, Title 45, Section 96.14(a) requires the State to obligate any Community Services Block Grant amounts by the end of the fiscal year following the fiscal year in which the amounts are awarded.

CONDITION

The Department of Community Services and Development (Community Services) did not ensure that it obligated federal funds within the applicable period of availability for the Community Services Block Grant. Specifically, Community Services obligated $215,171 related to nine contracts after the two-year period of availability for these funds. When Community Services does not obligate its federal funds within the period of availability, the federal government may disallow these costs.

RECOMMENDATION

Community Services should ensure that it obligates Community Services Block Grant funds within the grant award's period of availability.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The funds in question were part of the Director's Community Services Block Grant Discretionary fund. While these funds were obligated after the two-year period of availability, the funds were spent within the federal time limits. Community Services will obligate all current and future discretionary funds within the allowable timeframes.

Reference Number:	2005-8-2
Federal Catalog Number:	93.268

Federal Program Title:	Immunization Grants
Federal Award Numbers and Calendar Years Awarded:	H23/CCH922507-01; 2002 H23/CCH922507-02; 2003
Category of Finding:	Period of Availability
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Immunization Grants program identified the following compliance requirement related to period of availability:

The Code of Federal Regulations, Title 45, Section 74.28, states that when a funding period is specified, a recipient may charge to the award only allowable costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the Health and Human Services awarding agency. The time period that the funds are available to be obligated is stated on the grant notification letter.

CONDITION

The Department of Health Services (Health Services) did not always ensure that it charged the Immunization Grants program only for costs resulting from obligations incurred during the funding period. For nine of 40 expenditures we reviewed, Health Services charged costs totaling $611,298, even though the related obligations were not incurred during the funding period. In eight instances, Health Services obligated the funds from 25 to 225 days after the end of the funding period because of delays in obtaining required signatures on contracts. In the remaining instance, Health Services approved the related purchase order the month after the funding period expired. According to the chief of Field Services, Vaccine Management, and Contracts Section, the Immunization Branch thought it could submit a memo to accounting to encumber funds by the end of the funding period in cases in which the contract would not be finalized until after the funding period. However, the chief also acknowledges that contracts must be signed to obligate funds and funds must be obligated during the funding period. When Health Services does not obligate funds within the funding period of the grant, it risks having to refund the funds to the federal awarding agency.

RECOMMENDATION

Health Services should ensure that it obligates funds within the appropriate funding period of each grant award, which includes obtaining the appropriate signatures on contracts and purchase orders timely.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services concurs with the findings and subsequent recommendations. It was the understanding of Health Services that by encumbering funds within the appropriate funding period that we were in compliance with the period of availability. To correct this condition, Health Services will put check points in place to ensure that contracts and purchase orders are executed during the period of availability. In addition, Health Services will communicate with all contractors and explain the consequential denial of funding if contracts are not signed and submitted to Health Services by stated deadline.

Reference Number:	2005-8-4
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention—Investigation and Technical Assistance[4]
Federal Award Number and Calendar Year Awarded:	U90/CCU917016-04; 2003
Category of Finding:	Period of Availability
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Public Health Preparedness and Response for Bioterrorism program identified the following compliance requirement related to period of availability:

The Code of Federal Regulations, Title 45, Section 92.23, states that a grantee must liquidate all obligations incurred under the award not later than 90 days after the end of the funding period (or as specified in a program regulation) to coincide with the submission of the annual Financial Status Report. The federal agency may extend this deadline at the grantee's request.

CONDITION

The Department of Health Services (Health Services) liquidated obligations incurred under its fiscal year 2003-04 grant award more than 90-days after the award's funding period had expired without requesting an extension from the U.S. Department of

[4] This finding related to the Public Health Preparedness and Response for Bioterrorism program portion of this federal program.

Health and Human Services to do so. Specifically, Health Services paid these obligations, totaling about $8.3 million, more than 90 days to as much as 10 months after the award's funding period had expired. Health Services risks having to return funds to the federal awarding agency when it fails to obtain approval to liquidate these obligations after the 90-day period.

RECOMMENDATION

Health Services should ensure that it obtains the U.S. Department of Health and Human Services' approval to liquidate obligations beyond the 90-day period.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services disagrees with the audit findings but agrees that its request to the federal government should be more specific. On December 30, 2004, Health Services sent a letter to the Centers for Disease Control and Prevention (CDC) requesting the carryover of both unobligated and unexpended funds. The accompanying 2004-05 Interim Feasibility Study Report included $6 million in unobligated funds and $17 million in unliquidated funds. Although Health Services requested the carryover of both unobligated and unexpended funds, the letter did not cite the specific dollar amount for the unliquidated funds. In all future carryover requests, Health Services will clarify that it wishes to extend the time frame for liquidating obligated funds as well as carryover any unobligated funds specifying the dollar amount under each category and the timeframe of the requested extension.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

According to CDC, an agency of the U.S. Department of Health and Human Services, the letter Health Services sent to it requesting the carryover of both unobligated and unexpended funds is neither the same as nor an acceptable substitute for a request for an extension to liquidate all obligations. Consequently, we stand by our finding and are pleased that Health Services plans to request such extensions in the future.

Reference Number:	2005-9-1
Federal Catalog Number:	93.563
Federal Program Title:	Child Support Enforcement
Federal Award Number and Calendar Year Awarded:	75-X-1501; 2004

Category of Finding: Suspension and Debarment

State Administering Department: Department of Child Support Services

CRITERIA

Our review of the Child Support Enforcement program identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 45, Section 76.115, prohibits an excluded party from participating in federal assistance programs. Additionally, Section 76.300 requires the State to verify that the party with which it intends to do business is not presently excluded or disqualified by reviewing the excluded party list, obtaining a certification that the party is not excluded or disqualified, or adding a clause or condition to the covered transaction. The Department of Child Support Services (DCSS) has chosen to obtain a certification as its primary method of verification.

CONDITION

DCSS did not obtain the required suspension and debarment certification from any local child support agencies. Without obtaining the required certification, DCSS risks unknowingly allowing suspended or debarred parties to participate in the federal program. DCSS plans to include the suspension and debarment certification in its fiscal year 2005-06 agreements with local child support agencies. We used an alternative test to determine that the local child support agencies had not been suspended or debarred.

RECOMMENDATION

DCSS should ensure that it obtains the necessary suspension and debarment certifications from local child support agencies before it approves their participation in federal programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

DCSS will ensure suspension and debarment language is included in the next plan of cooperation (POC) for local child support agency (LCSA) review and approval. It was the department's intention that a new POC be prepared and sent to all LCSAs in federal fiscal year (FFY) 2004-05. However, revisions to the POC were deferred to include a number of additional changes that needed to be made to ensure that the POC was more closely matched with both State and federal statute.

The revised POC for FFY 2005-06 is in final draft and is expected to be disseminated in January 2006. Suspension and Debarment language has been added to the POC.

Once approved for dissemination, a copy of the POC will be provided to the audit team.

Reference Number:	2005-12-4
Federal Catalog Number:	93.767
Federal Program Title:	State Children's Insurance Program
Federal Award Numbers and Calendar Years Awarded:	05-03A5CA5021; 2003 05-02A5CA5021; 2002
Category of Finding:	Reporting
State Administering Department:	Department of Health Services

CRITERIA

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, Compliance Supplement, requires the State to submit the Centers for Medicare and Medicaid Services report titled *Quarterly Children's Health Insurance Program Statement of Expenditures for Title XXI* (CMS-21).

The Code of Federal Regulations, Title 45, Section 74.21 requires that the recipients' financial management system provide for accurate, current and complete disclosure of the financial results of each project or program sponsored by the U.S. Department of Health and Human Services. In addition, the financial management system must provide accounting records that are supported by source documentation.

CONDITION

The Department of Health Services (Health Services) does not ensure that amounts reported on its quarterly CMS-21 report are classified correctly. Although the total amounts spent on the program reported by Health Services are accurate, we were unable to verify the accuracy of detailed expenditures reported by line item or category of service. Our review of the first quarter report for fiscal year 2004-05 revealed that Health Services was unable to provide supporting documentation for amounts totaling $383,271 that it reported in the Inpatient Hospital Services category. Further, whatever Health Services incorrectly reported in the Inpatient Hospital Services category, it misstated in at least one other category of service.

According to Health Services, it does not receive enough information from its fiscal intermediary to be able to reconcile and accurately report program expenditures by

category of service as required. Health Services is aware of the issue and is working to obtain additional information from its fiscal intermediary to resolve the differences so it can report all the information accurately on its quarterly CMS-21 report.

RECOMMENDATION

Health Services should work with its fiscal intermediary to obtain reports that it can use to accurately report all program expenditures by category of service.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

We concur with the audit finding. Health Services' Payment Systems Division has submitted a request to the fiscal intermediary to make changes in the automated system to provide the necessary information required to accurately report expenditures by category on the CMS-21 report. It is anticipated that the change will be made prior to June 30, 2006.

Reference Number:	2005-13-3
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Child Care Mandatory and Matching Funds of the Child Care and Development Fund program and the Child Care and Development Block Grant program (child care cluster programs) determined that the following compliance requirements relate to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), Section 400(d), requires the State to identify federal award information to subrecipients at the time of the award. This includes such information as the Catalog of Federal Domestic Assistance title and number, award name and number, and name of the federal agency.

Further, the Code of Federal Regulations, Title 45, Section 98.11(b)(4), requires the Department of Education (Education) to ensure that the child care cluster programs comply with all federal requirements and Education's Child Care and Development

Fund Plan (plan), which was submitted to and approved by the U.S. Department of Health and Human Services. In the approved plan, Education committed to reviewing every three years each contractor providing local child care and development services.

CONDITION

Education did not adequately fulfill its subrecipient monitoring responsibilities for the child care cluster programs. Specifically, for 10 of the 40 award documents we reviewed, Education did not provide subrecipients with the name of the federal awarding agency or the applicable federal laws and regulations. Further, in three of these 10 instances, Education also did not provide subrecipients with the federal catalog number. According to Education, for six of the 10 cases it inadvertently omitted the name of the federal agency and applicable laws and regulations when it attempted to combine the standard contract provisions for state and federally funded grants. In the other four cases, Education asserted that these two items were left out due to staff oversight. Finally, Education indicated that it left out the federal catalog number for three of our sample items at the direction of its accounting unit. However, Education plans to include this information in the future. When Education does not identify all the required federal award information, it cannot ensure that subrecipients of the child care cluster programs correctly identify all their federal grant awards. As a result, subrecipients' independent auditors, who must conduct audits in accordance with OMB Circular A-133, may not be aware of all grants they must consider for audit.

In addition, Education lacks sufficient procedures to ensure that it performs contract-monitoring reviews (CMR) within the required three-year period as established in its plan. Specifically, although Education's management approved a CMR schedule for fiscal year 2004-05, Education did not have a system in place to monitor whether its staff actually performed the CMRs. Thus, Education has no assurance that the CMRs were conducted and that it is meeting its obligations as established in the plan. In fact, we found that for 15 of the 40 subrecipients we reviewed, Education did not conduct CMRs within the required three-year period. The extent to which Education was late in conducting these CMRs ranged from two months to four years. Failure to perform CMRs in accordance with its plan may prevent early detection and correction of deficiencies in the services provided by subrecipients.

RECOMMENDATIONS

Education should ensure that it provides all the required federal award information to subrecipients. Additionally, it should take the steps necessary to monitor and ensure that its staff perform CMRs at least every three years, in accordance with its plan.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education administered contracts for child care cluster programs have and continue to contain all required federal award information as required by OMB Circular A-133. However, information on the federal awarding agency name, the applicable federal laws and regulations, and the federal catalog number was inadvertently omitted from the 2004-05 Funding Terms & Conditions (FT&Cs) related to 1 of 27 child care programs administered by Education, effecting 58 contracts. Federal award information was provided in the 2004-05 FT&Cs in all other programs and contracts within those programs, as has been Education's historical practice. This single oversight resulted from large-scale changes in the FT&Cs related to contract consolidation and simplification undertaken by Education in response to recommendations from the Legislature. The oversight was corrected for the 2005-06 fiscal year.

Education will develop procedures to collect and maintain CMR information in a central location and use the information to monitor the frequency of reviews. During fiscal year 2004-05, based on instructions from both the Legislative and Department of Finance staff, Education redirected all staff conducting CMRs to perform the Error Rate Study mandated by the Health and Human Services Trailer Bill (Chapter 229, Statutes of 2004, Senate Bill 1104, Committee on Budget and Fiscal Review). Of the 15 subrecipients that Education did not conduct a CMR within the required three-year period, 14 were delayed because of the mandated Error Rate Study.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Despite its opening statement to the contrary, Education acknowledges that it did not provide subrecipients of the two federal programs we audited—the Child Care Development Block Grant and the Child Care Mandatory and Matching Funds of the Child Care and Development Fund—all of the award information required by OMB Circular A-133. We can neither confirm nor refute Education's assertion that this oversight did not occur in any of the other child care programs it administers because we did not audit them. However, we would remind Education that OMB Circular A-133 requires that we report on compliance for each program rather than for all programs in the aggregate.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.575
Federal Program Title:	Child Care and Development Block Grant
Federal Award Number and Calendar Year Awarded:	2004 G996005; 2004

Federal Catalog Number:	93.596
Federal Program Title:	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Numbers and Calendar Years Awarded:	2004 G999004; 2004 2004 G999005; 2004

Reference Number:	2005-13-4
Federal Catalog Number:	93.917
Federal Program Title:	HIV Care Formula Grants
Federal Award Number and Calendar Year Awarded:	6X07HA0004-14; 2004
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the HIV Care Formula Grants program identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* (OMB Circular A-133), Section 400(d)(3), requires the State to monitor subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved. In its state application for funding to administer the HIV Care Formula Grants program, the Department of Health Services (Health Services) established specific timeframes for conducting periodic monitoring site visits of its case management and care services subrecipients. Specifically, in its state application for grant funds, Health Services specified that program staff for case management would perform routine site visits of its subrecipients at least every 18 months and program staff for care services would perform site visits no less than once per three-year period. The state application also indicated that Health Services would provide a written report documenting the results of the reviews and require corrective action plans, if needed, from subrecipients. Additionally, Health Services has established an internal policy

with a goal that case management staff will submit written reports to subrecipients documenting the results of the site visits within 90 days of the site visit.

Further, OMB Circular A-133 describes the audit requirements for recipients of federal funds. Section 200 requires subrecipients spending $500,000 or more annually in federal awards to have A-133 audits. Section 320 requires the submission of the audit report to the State for review within nine months of the end of the subrecipient's audit period. For subrecipients of HIV Care Formula Grants funds that do not submit audit reports on time, Health Services has established an internal policy requiring follow-up with subrecipients at 90 days and 180 days after the due date of the audit report.

CONDITION

In its state application for funding to administer the HIV Care Formula Grants program, Health Services identified site visits as a key component of its subrecipient monitoring process. However, Health Services did not perform site visits as frequently as the timeframes specified in its state application and did not always provide written reports to subrecipients within required timeframes. Specifically, we found that:

- Health Services did not conduct site visits within the 18-month period ending June 30, 2005, for five of 20 subrecipients of the case management program that received funding for the 18-month period. It completed four of the site visits from three to 14 months late. At the conclusion of our audit fieldwork, Health Services also had not completed the fifth site visit, which was four months late. According to program management, Health Services was unable to complete all site visits on time because of vacant positions that were a result of budget cuts and the inability to hire staff because of nursing shortages. Although Health Services did not complete all site visits within 18 months, it has improved significantly over last year's results. In our previous audit report, we noted that the case management program did not complete 10 of 20 site visits on time.
- Health Services did not conduct site visits for 11 of 37 subrecipients of the care services program within the three years ending on June 30, 2005.

In addition, Health Services did not provide written reports documenting the results of site visits within 90 days to four of five case management program subrecipients reviewed. In three instances, Health Services sent the written reports from 71 to 250 days late. In another instance, it had not yet sent the report, which was already more than 100 days late, as of September 30, 2005.

Further, Health Services did not follow its procedures to ensure that it received audit reports promptly from one of 10 nonprofit subrecipients that received more than $500,000 in HIV Care Formula Grant funds. Specifically, Health Services received this subrecipient's audit report 160 days late. Although it sent out late notices prior to and within 30 days after the federal due date, it did not complete subsequent follow-up at 90 days as required.

Because it does not conduct site visits within the frequency it established in its state application, Health Services has less assurance that subrecipients are complying with applicable laws, regulations, and provisions of contracts or grant agreements. Also, Health Services' failure to obtain audit reports promptly may prevent early detection and correction of deficiencies in services provided by subrecipients.

RECOMMENDATIONS

Health Services should ensure that it conducts site visits in accordance with its state application and should ensure that it provides written reports documenting results of site visits to its subrecipients within the timeframes established. Health Services also should ensure that its staff members follow its process for following up on delinquent audit reports from subrecipients.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Case Management Program (CMP):

Did not conduct site visits within the 18-month period ending June 30, 2005.

Health Services concurs. CMP's self-established goal is to visit each subrecipient every 18 months. Of the five sites not visited within that timeframe, four visits have been completed and the fifth is scheduled for February 8, 2006. Site visits are performed by a monitoring team consisting of a Health Program Analyst (HPA), a Registered Nurse (RN), and a Social Worker. During the period of this audit, one of four HPA positions was vacant for six months due to budgetary cut backs. Of the two RN positions only one was filled for a six-month period due to the general shortage of nurses in State service. The posting of vacant nurse positions has just ended and applications have been received from qualified candidates. Assuming staffing issues are resolved future site visits should be concluded within the required timeframe.

Care Services Program (CSP):

Did not conduct site visits for 11 of 37 subrecipients.

Health Services concurs. This process is guided by resources available within the program. This year resources were limited due to prolonged staff vacancies. The Office of AIDS' Care Services section which administers the CSP reduced the number of vacancies within the CSP. The CSP has completed three of the eleven county monitoring requirements and the remaining is projected to be completed before the end of December 2006. In addition to monitoring by program and fiscal staff, the CSP annually funds a full time auditor assigned by Health Services, Audits and Investigations Division.

CMP:

Did not provide written reports documenting the results of site visits.

Health Services concurs. CMP's self-established goal is to present a report of the results of a site visit to a subrecipient within 90 days of the visit. This goal was not

attained due to staff shortages during this period. With a higher level of current staffing, and more careful monitoring of report submissions, this requirement should be met during fiscal year 2005-06.

CMP:

Did not follow its procedures to ensure that it promptly received audit reports from non-profit subrecipients.

Delinquent Audit Report:

Inland AIDS Foundation: Health Services concurs. Records indicate the A-133 Audit was due to Office of AIDS April 30, 2005. A delinquent notice was sent May 24, 2005, but no follow-up was done until the audit was received four months later.

The Community Based Care Section will continue to closely monitor audit responses using the data base designed for that purpose. It also, during the course of this audit, received clarifications from Bureau of Audits on due dates, and required follow-up activity.

Reference Number:	2005-13-6
Federal Catalog Number:	93.268
Federal Program Title:	Immunization Grants
Federal Award Numbers and Calendar Years Awarded:	H23/CCH922507-01; 2002 H23/CCH922507-02; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Immunization Grants program identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the requirements the State must follow when it passes federal funds through to subrecipients. Section 400(d) requires the State to inform each subrecipient of specific federal award information, including the Catalog of Federal Domestic Assistance (CFDA) title and number, the award name and number, and the name of the federal agency. Section 400(d) also requires the State to ensure that

subrecipients expending $500,000 or more in federal assistance meet applicable audit requirements, including the submission of an audit report to the State within nine months after the end of the audit period.

CONDITION

The Department of Health Services (Health Services) did not fulfill its subrecipient monitoring responsibilities for its Immunization Grants program. Specifically, for the 40 subrecipients we reviewed, Health Services did not provide required grant-related information such as the CFDA title and number, the award name and number, and the name of the federal agency. According to the Immunization Branch's Chief of Field Services, Vaccine Management, and Contracts Section, the Immunization Branch was not aware of this federal requirement until our audit raised the question. When Health Services does not identify the federal award information, it cannot ensure that subrecipients of the Immunization Grants program correctly identify all their federal grant awards. As a result, subrecipients' independent auditors who must conduct audits in accordance with OMB Circular A-133 may not be aware of all grants they must consider for audit. The State uses the independent audits as one method to monitor subrecipients' compliance with applicable federal requirements and program goals.

Moreover, Health Services did not determine whether any of its five nonprofit subrecipients were required to submit audit reports. Based on information available at Health Services, we determined that it provided at least $500,000 in federal assistance during fiscal year 2003-04 from the Immunization Grants program to two of its five nonprofit subrecipients. Although Health Services' Immunization Branch received an audit report from one of these two subrecipients and had a process in place to follow up on findings related to the program for any audit reports received, it was unaware that it should have procedures to ensure that it received all required audit reports in a timely manner from the nonprofit subrecipients required to submit them. Without an effective system to identify all nonprofit subrecipients required to have audits and to track the prompt receipt of these required audit reports, Health Services has reduced assurance that its nonprofit subrecipients are spending federal assistance according to applicable laws and regulations.

RECOMMENDATIONS

Health Services should ensure that it identifies and provides all required federal award information to subrecipients of the Immunization Grants program at the time of the awards. Also, Health Services should establish procedures to identify those nonprofit subrecipients required to submit audit reports and should obtain audit reports from them in a timely manner.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services concurs with the findings and subsequent recommendations. The process for preparing awards to subrecipients has already been updated to include the notification of all required federal award information. As mentioned in the audit findings, Health Services was previously unaware of this requirement.

In addition, as a result of the audit, Health Services now understands its role in:

1) identifying those required to submit audit reports and
2) its responsibility in monitoring the submission of said reports.

To comply with this condition Health Services will put check points in place to ensure that audit reports are received and reviewed in a timely manner.

Reference Number:	2005-14-2
Federal Catalog Number:	93.053
Federal Program Title:	Nutrition Services Incentive Program
Federal Award Numbers and Calendar Years Awarded:	04AACANSIP; 2003 05AACANSIP; 2005
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Aging

CRITERIA

Our review of the Nutrition Services Incentive Program identified the following compliance requirement related to special tests and provisions:

The United States Code, Title 42, Section 3030a (d)(2), requires states to promptly and equitably distribute cash received in lieu of commodities to recipients of grants or contracts. The Department of Aging (Aging) generally distributes cash quarterly to Area Agencies on Aging (area agencies) based on the proportion of meals each area agency serves of the total meal counts reported in the prior year.

CONDITION

Although Aging has implemented a process to ensure the prompt and equitable distribution of the cash it receives in lieu of commodities to its area agencies for its Nutrition Services Incentive Program, we found that it did not follow its process during

fiscal year 2004-05. Specifically, when determining the amount of cash to distribute to the area agencies, Aging used meal counts for only three quarters of a prior fiscal year rather than meal counts for that entire fiscal year as required. As a result, some area agencies received more Nutrition Services Incentive Program funding and others received less than they otherwise would have received. For example, Aging allocated $11,544 more to one area agency and $8,028 less to a second than these two area agencies would have received had Aging used the correct meal counts. According to Aging, it did not detect this error because staff did not follow its review process, which requires a supervisor to review the accuracy of the information and the calculations made by staff to determine the amount of cash to be distributed to each area agency. As a result of this error, Aging cannot ensure that it equitably distributed cash payments to its area agencies during fiscal year 2004-05.

RECOMMENDATION

Aging should ensure that its staff perform the appropriate reviews to ensure the accuracy of the information used in determining the amount of cash to distribute to the area agencies.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Aging concurs with this finding. Aging has formalized the existing procedures used to allocate funds for the Nutrition Services Incentive Program (NSIP). These procedures require both the Accounting Manager and the Budget Manager to review the annual NSIP allocations to insure Aging uses the appropriate full year meal counts as the basis for allocating the funds.

Reference Number:	2005-14-4
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0405CA5028; 2004 05-0505CA5028; 2004, 2005
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 42, sections 431.51(b) and (c), allows recipients to obtain Medicaid services from any provider qualified and willing to furnish the services. However, these regulations do not prohibit the state Medicaid agency from setting reasonable standards for provider qualifications. For example, the California Welfare and Institutions Code, Section 14043.6, requires automatic suspension from the state Medicaid program for any provider whose license, certificate, or other approval has been revoked or suspended by a federal, California, or another state's licensing, certification, or approval authority, or has been otherwise lost or surrendered while a disciplinary hearing was pending. Additionally, the Code of Federal Regulations, Title 42, Section 442.101, requires specific Medicaid facilities to obtain certification. Sections 455.104 through 455.106 identify disclosures providers must provide, and Section 431.107 requires an agreement between the State and each provider.

CONDITION

Our review of selected Medicaid providers revealed that the Department of Health Services (Health Services) did not always have the required agreements, disclosures, and certifications on file. Of the 30 providers we reviewed, Health Services did not have provider agreements on file for 15 providers and did not have the required disclosure on file for one provider. Further, when we questioned Health Services, it discovered that one provider we reviewed was not certified properly. According to Health Services' Provider Enrollment Branch chief, it is pursuing a temporary suspension from the Medicaid program for the provider without appropriate certification. In response to similar findings in our fiscal year 2002-03 and 2003-04 audit reports, Health Services indicated it has implemented a reenrollment process and will reenroll all Medicaid providers on a continuous basis. This process will verify and update enrollment information and help ensure compliance with state and federal regulations. According to Health Services, it continues to prioritize provider types for the reenrollment process based on the provider types with the highest risk.

When Health Services cannot demonstrate that it has obtained provider certifications, proper agreements, and disclosures, it cannot ensure that it made Medicaid claim payments only to eligible providers.

RECOMMENDATION

Health Services should continue its reenrollment process to ensure that it obtains the appropriate certifications, agreements, and disclosures.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services concurs with this recommendation. Health Services continues to categorize reenrollment of those providers originally enrolled prior to 1998 as a high priority in its effort to reduce fraud in the Medi-Cal program, by assuring that only those eligible providers will be allowed to bill Medi-Cal.

The reenrollment plan will insure that all Medi-Cal providers will be re-examined, as a continuous process, to verify and update their original enrollment information and to ensure continued compliance with current state and federal regulations. The Provider Enrollment Branch (PEB) continues to implement procedures to more efficiently review and process reenrollment applications based upon data driven targeting of established fraud indicators (consistent with the Malcolm Sparrow anti-fraud model). As part of this process, high-risk provider types will continue to be identified, by PEB and Audits and Investigations (A&I) using an on-going risk assessment analysis and the annual Medi-Cal Payment Error Study (MPES), allowing PEB to prioritize the review of these providers reenrollment. This will provide for the verification and update of the original provider enrollment information, ensuring compliance with current state and federal regulations.

PEB will annually review current practices to identify and prioritize policies and procedures that can be updated and streamlined, facilitating the reenrollment process.

The reenrollment plan is included in Health Services' Medi-Cal Fraud Control Strategic Plan. A&I and PEB will implement the plan for reenrollment of all high-risk provider types such as physician groups identified in the 2004 MPES in fiscal year 2005-06. A&I and PEB will develop and implement a process to incorporate the results of each MPES in annual reenrollment production plans in fiscal year 2006-07. The plan for reenrolling providers on a continuous basis will be developed by June 30, 2006.

With respect to health facilities certified by Health Services' Licensing and Certification Division (L&C), L&C amended its licensure application forms to include the disclosure requirements under Code of Federal Regulations, Title 42, Sections 455.104 through 106. The final draft is undergoing legal review, and will be implemented upon clearance. L&C is also coordinating with Medi-Cal in developing the provider agreements for non-long term care facilities. L&C will be reviewing Medi-Cal's proposed provider agreement, which is in final draft, and will be evaluating options for either adopting the agreement, with special instructions for health facilities, or developing a more health facility-specific version. L&C hopes to achieve compliance to these requirements by June 30, 2006.

U.S. DEPARTMENT OF HOMELAND SECURITY

Reference Number:	2005-9-3
Federal Catalog Number:	97.004 (formerly 16.007)
Federal Program Title:	State Domestic Preparedness Equipment Support Program
Federal Award Numbers and Calendar Years Awarded:	2002-TE-CX-0088; 2002 2002-TE-CX-0133; 2002 2003-MU-T3-0035; 2003 2003-TE-TX-0167; 2003 2004-GE-T4-0045; 2004
Category of Finding:	Suspension and Debarment
State Administering Departments:	Governor's Office of Emergency Services[5] Governor's Office of Homeland Security

CRITERIA

Our review of the State Domestic Preparedness Equipment Support Program identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 28, Section 66.35, requires that the State neither make an award nor permit a subgrantee to make an award to any party that is debarred or suspended or is otherwise excluded from or ineligible from participating in federal assistance programs. Further, Title 28, Section 67.300, states that before entering into a covered transaction with another party, recipients of federal funds must verify that the other party is not excluded or disqualified by checking the Excluded Parties List System, collecting a certification from the other party, or adding a clause or condition to the covered transaction with that party.

CONDITION

The Governor's Office of Emergency Services (Emergency Services) did not have adequate procedures to ensure that subrecipients receiving funds from the State Domestic Preparedness Equipment Support Program were not suspended or debarred. Before making awards to subrecipients, Emergency Services did not check the federal listing of debarred and suspended parties, obtain certifications stating that the subrecipients were not debarred or suspended, nor add a clause or condition to

[5] Until March 2005, the Governor's Office of Emergency Services administered the State Domestic Preparedness Equipment Program. Beginning in March 2005, the Governor's Office of Homeland Security took over this program's administration.

covered transactions. Because Emergency Services did not take any of these steps, it risked unknowingly allowing suspended or debarred parties to participate in this federal program. However, for the 33 subrecipients that we reviewed, we used an alternative test to determine that they had not been suspended or debarred.

RECOMMENDATION

Before awarding funds from federal grant programs to subrecipients, the Governor's Office of Homeland Security (Homeland Security) should take one of the following steps: check the federal listing of suspended and debarred parties; require certifications from subrecipients stating that they and their key employees are not suspended or debarred; or add a clause or condition to covered transactions with subrecipients.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

Emergency Services: For State Domestic Preparedness Equipment Support Program grants awarded through March 31, 2005, Emergency Services agrees with the finding. Homeland Security assumed all programmatic and administrative responsibility for these grants on April 1, 2005. Consequently, Emergency Services cannot provide a response for grants awarded on or after April 1, 2005, and does not have the responsibility for implementing a corrective action plan.

Homeland Security: Before awarding funds from federal grant programs to subrecipients, Homeland Security will ensure that it did not provide federal financial assistance to a suspended or debarred party by verifying that the party is not excluded or disqualified by looking at the excluded parties list, and by adding a clause or condition to our "certification" list with that party.

Reference Number:	2005-12-2
Federal Catalog Number:	97.036
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2004-05
Category of Finding:	Reporting
State Administering Department:	Governor's Office of Emergency Services

CRITERIA

Our review of the Public Assistance Grants program identified the following compliance requirement related to reporting:

The Code of Federal Regulations, Title 44, Section 206.204(f) requires the Governor's Office of Emergency Services (Emergency Services) to submit quarterly progress reports for the Public Assistance Grants program to the Federal Emergency Management Agency, part of the U.S. Department of Homeland Security.

CONDITION

Emergency Services reported incorrect financial information in its March 2005 quarterly progress report. Specifically, Emergency Services did not include two of the 20 projects we reviewed in the report. As a result, Emergency Services understated project obligations by $173.3 million and project expenditures by $156.8 million. According to one of its program managers, Emergency Services was unable to determine why it did not include these two projects in its progress report. He further stated that Emergency Services has rewritten a computer query and that he believes the concern is now resolved.

RECOMMENDATION

Emergency Services should develop and implement a process for reviewing quarterly progress reports to ensure that they are complete and accurate.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services agrees with the finding and has corrected the financial database report to reflect the accurate data for the following quarter. In the future, the financial data will be cross-referenced with the program report for accuracy.

Reference Number:	2005-12-6
Category of Finding:	Reporting
State Administering Department:	Governor's Office of Emergency Services

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Public Assistance Grants and Hazard Mitigation Grant programs determined that the following compliance requirements relate to reporting:

The Code of Federal Regulations, Title 44, Section 13.20, requires the Governor's Office of Emergency Services (Emergency Services) to maintain fiscal controls and accounting procedures to properly track and accurately report financial activities related to federal grants. Additionally, Section 13.41(b) requires Emergency Services to use the financial status report form to report on the status of federal funds for nonconstruction grants. To meet this requirement, the Federal Emergency Management Agency (FEMA), an agency within the U.S. Department of Homeland Security, requires Emergency Services to submit quarterly financial status reports for each disaster. FEMA mandates that these status reports are to include total recipient and subrecipient nonfederal expenditures and administrative expenses.

CONDITION

Emergency Services' financial status reports do not always contain complete expenditure information. We tested 22 financial status reports for the quarter ending March 2005—of which 20 contained information for the Hazard Mitigation Grant program and 20 contained information for the Public Assistance Grants program. We found that of the 20 financial status reports for the Hazard Mitigation Grant program, 16 did not identify Emergency Services share of outlays while none identified the subrecipients' shares of outlays. Although Emergency Services now reports its share of outlays under the Hazard Mitigation Grant program for those disasters that occurred in October 2003 and later, Emergency Services states that it does not have a process to capture the expenditure information it receives from subrecipients. Further, Emergency Services did not separately disclose its and the subrecipients' administrative costs in any of the 22 financial status reports. FEMA requires separate reporting of administrative expenditures.

RECOMMENDATIONS

Emergency Services should report the subrecipients' share of Hazard Mitigation Grant program outlays. Additionally, Emergency Services should separately report its and the subrecipients' administrative costs per FEMA instructions.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services has made several attempts over the years to discuss with FEMA how best to report California disaster activity (which involves more than 20,000 plus individual projects) into a single generic format. Given the repeat nature of this finding, Emergency Services will continue to work with FEMA management to reach a

consensus on how to report on-going disaster activity. Additionally, Emergency Services will review its internal fiscal and grant tracking systems to determine the availability of information.

U.S. DEPARTMENT OF HOMELAND SECURITY

Federal Catalog Number:	97.036
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2004-05

Federal Catalog Number:	97.039
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2004-05

Reference Number:	2005-14-5
Federal Catalog Number:	97.067
Federal Program Title:	Homeland Security Grant Program
Federal Award Number and Calendar Year Awarded:	2005-GE-T5-0015; 2005
Category of Finding:	Special Tests and Provisions
State Administering Department:	Governor's Office of Homeland Security

CRITERIA

Our review of the Homeland Security Grant Program determined the following compliance requirements related to Special Tests and Provisions:

The 2005 grant provisions for four of the six programs under the Homeland Security Grant Program require the Governor's Office of Homeland Security (Homeland Security) to obligate at least 80 percent of the total grant amount to subrecipients within 60 days of the grant award date. These provisions also require Homeland

Security to comply with the Office of Justice Programs Financial Guide, which states that an obligation is incurred when funds are encumbered. Homeland Security encumbers funds when it approves a subrecipient's application for grant funding.

CONDITION

Homeland Security did not obligate 80 percent of the 2005 Homeland Security Grant Program funds to subrecipients within 60 days of receiving the grant award for the four programs to which this requirement applies. Specifically, despite receiving its grant award on March 14, 2005, Homeland Security did not obligate 80 percent of the funds until August 10, 2005, nearly three months late. According to the assistant deputy director for grants management, Homeland Security did not obligate these funds within the 60 days because it believed it first needed the U.S. Department of Homeland Security's approval of the State's Initial Strategy Implementation Plan (strategy plan). When an official with the U.S. Department of Homeland Security informed Homeland Security on August 9, 2005, that the obligation of the funds was not tied to the approval of the strategy plan, Homeland Security obligated on the next day amounts to each of the four programs that were equal to or in excess of the 80 percent required by the grant's provisions. Because it did not obligate these funds within the required 60 days, however, Homeland Security may have unnecessarily delayed the subrecipients' ability to conduct homeland security activities covered by the grant.

RECOMMENDATION

Homeland Security should ensure that it obligates 80 percent of the funds to its subrecipients within 60 days of receiving its federal award.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Henceforth, Homeland Security will ensure it obligates all required federal funds within the mandatory 60-day receipt of award.

AUDITEE’S SECTION

Schedule of Federal Assistance

Prepared by
Department of Finance

STATE OF CALIFORNIA
SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2005

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Department of Agriculture			
Plant and Animal Disease, Pest Control, and Animal Care	10.025	31,812	
Wetlands Reserve Program	10.072	9,000	
Market Protection and Promotion	10.163	360,256	
Farm Labor Housing Loans and Grants	10.405	1,648,576	
Food Donation	10.550	96,012,810	*
Special Supplemental Nutrition Program for Women, Infants, and Children	10.557	831,263,913	
Child and Adult Care Food Program	10.558	245,934,036	
State Administrative Expenses for Child Nutrition	10.560	16,909,612	
Commodity Supplemental Food Program	10.565	3,131,361	
WIC Farmers' Market Nutrition Program (FMNP)	10.572	2,407,325	
Team Nutrition Grants	10.574	133,816	
Senior Farmers Market Nutrition Program	10.576	490,796	
Cooperative Forestry Assistance	10.664	3,840,989	
Schools and Roads-Grants to States	10.665	63,143,502	
National Forest-Dependent Rural Communities	10.670	153,795	
Rural Development, Forestry, and Communities	10.672	4,424	
Forest Stewardship Program	10.678	131,791	
Other - U.S. Department of Agriculture	10.999	29,124,760	
Total Excluding Clusters		1,294,732,574	
Food Stamp Cluster			
Food Stamps	10.551	2,262,419,409	*
State Administrative Matching Grants for Food Stamp Program	10.561	388,092,594	
Total Food Stamp Cluster		2,650,512,003	
Child Nutrition Cluster			
School Breakfast Program	10.553	236,372,005	
National School Lunch Program	10.555	919,804,444	
Special Milk Program for Children	10.556	791,476	
Summer Food Service Program for Children	10.559	13,956,600	
Total Child Nutrition Cluster		1,170,924,525	
Emergency Food Assistance Cluster			
Emergency Food Assistance Program (Administrative Costs)	10.568	6,795,453	
Emergency Food Assistance Program (Food Commodities)	10.569	48,376,447	*
Total Emergency Assistance Cluster		55,171,900	
Research & Development Cluster			
Agricultural Research-Basic and Applied Research	10.001	17,731	
Total U.S. Department of Agriculture		5,171,358,733	
Department of Commerce			
Economic Development-Support for Planning Organizations	11.302	100,000	
Anadromous Fish Conservation Act Program	11.405	940,143	
Interjurisdictional Fisheries Act of 1986	11.407	162,549	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Coastal Zone Management Administration Awards	11.419	5,610,471	
Coastal Zone Management Estuarine Research Reserves	11.420	2,937,776	
Marine Sanctuary Program	11.429	70,455	
Pacific Coast Salmon Recovery-Pacific Salmon Treaty Program	11.438	8,432,151	
Habitat Conservation	11.463	64,487	
Fisheries Disaster Relief	11.477	288,708	
Other - U.S. Department of Commerce	11.999	17,949	
Total U.S. Department of Commerce		18,624,689	
Department of Defense			
Navigation Projects	12.107	67,529	
Planning Assistance to States	12.110	2,967,940	
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113	11,808,635	
Military Construction, National Guard	12.400	1,822,200	
National Guard Military Operations and Maintenance (O&M) Projects	12.401	48,825,478	
National Guard Civilian Youth Opportunities	12.404	4,874,125	
Other - U.S. Department of Defense	12.999	2,273,699	
Total Excluding Clusters		72,639,606	
Research & Development Cluster			
Aquatic Plant Control	12.100	90,119	
Total U.S. Department of Defense		72,729,725	
Department of Housing and Urban Development			
Manufactured Home Construction and Safety Standards	14.171	223,038	
Community Development Block Grants/State's Program	14.228	43,727,769	
Emergency Shelter Grants Program	14.231	6,106,342	
Supportive Housing Program	14.235	4,989,427	***
HOME Investment Partnerships Program	14.239	97,648,633	***
Housing Opportunities for Persons with AIDS	14.241	2,675,129	
Equal Opportunity in Housing	14.400	2,709,147	
Lead-Based Paint Hazard Control in Privately-Owned Housing	14.900	50,726	
Total Excluding Clusters		158,130,211	
Section 8 Project-Based Cluster			
Lower Income Housing Assistance Program - Section 8 Moderate Rehabilitation	14.856	48,878	
Section 8 Tenant-Based Cluster			
Section 8 Rental Voucher Program	14.855	3,853,924	
Total U.S. Department of Housing and Urban Development		162,033,013	
Department of the Interior			
Distribution of Receipts to State and Local Governments	15.227	10,918	
National Fire Plan - Wildland Urban Interface Community Fire Assistance	15.228	1,151,838	
Small Reclamation Projects	15.503	286,533	
Water Reclamation and Reuse Program	15.504	5,698	
Anadromous Fish Conservation	15.600	32,994	
Endangered Species Conservation	15.612	407,854	
Coastal Wetlands Planning, Protection and Restoration Act	15.614	611,582	
Cooperative Endangered Species Conservation Fund	15.615	2,574,707	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Clean Vessel Act	15.616	819,000
Sportfishing and Boating Safety Act	15.622	194,260
Wildlife Conservation and Restoration	15.625	73,984
Landowner Incentive	15.633	12,106
Earthquake Hazards Reduction Program	15.807	35,939
U.S. Geological Survey-Research and Data Collection	15.808	141,385
Historic Preservation Fund Grants-In - Aid	15.904	1,092,997
Outdoor Recreation-Acquisition, Development and Planning	15.916	3,937,926
Research Information	15.975	676,044
Other - U.S. Department of the Interior	15.999	29,387,328
Total Excluding Clusters		41,453,093
Fish and Wildlife Cluster		
Sport Fish Restoration	15.605	10,583,483
Wildlife Restoration	15.611	4,065,569
Total Fish and Wildlife Cluster		14,649,052
Research and Development Cluster		
Anadromous Fish Conservation	15.600	16,504
Coastal Wetlands Planning, Protection and Restoration Act	15.614	3,155
U.S. Geological Survey-Research and Data Collection	15.808	62,322
Total Research and Development Cluster		81,981
Total U.S. Department of the Interior		56,184,126

Department of Justice

State Domestic Preparedness Equipment Support Program	16.007	61,528,354
Offender Reentry Program	16.202	267,744
Juvenile Accountability Incentive Block Grants	16.523	4,991,475
Juvenile Justice and Delinquency Prevention-Allocation to States	16.540	5,637,040
Title V-Delinquency Prevention Program	16.548	1,559,617
Part E-State Challenge Activities	16.549	1,092,087
State Justice Statistics Program for Statistical Analysis Centers	16.550	51,586
National Criminal History Improvement Program (NCHIP)	16.554	2,646,948
National Institute of Justice Research, Evaluation, and Development Project Grants	16.560	416,233
Crime Laboratory Improvement-Combined Offender DNA Index System Backlog Reduction	16.564	2,522,341
Crime Victim Assistance	16.575	33,732,107
Crime Victim Compensation	16.576	26,636,714
Byrne Formula Grant Program	16.579	56,331,516
Edward Byrne Memorial State and Local Law Enforcement Assistance Discretionary Grants Program	16.580	141,764
Drug Court Discretionary Grant Program	16.585	50,898
Violent Offender Incarceration and Truth in Sentencing Incentive Grants	16.586	58,831,643
Violence Against Women Formula Grants	16.588	10,076,444
Rural Domestic Violence and Child Victimization Enforcement Grant Program	16.589	205,511
Local Law Enforcement Block Grants Program	16.592	2,590,494
Residential Substance Abuse Treatment for State Prisoners	16.593	5,936,978
State Criminal Alien Assistance Program	16.606	77,356,015
Community Prosecution and Project Safe Neighborhoods	16.609	1,370,731
Regional Information Sharing Systems	16.610	4,603,942
Public Safety Partnership and Community Policing Grants	16.710	4,397,692
Enforcing Underage Drinking Laws Program	16.727	315,478

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
National Incident Based Reporting System	16.733	46,891
Other - U.S. Department of Justice	16.999	890,593
Total Excluding Clusters		364,228,836
Research and Development Cluster		
National Institute of Justice Research, Evaluation, and Development Project Grants	16.560	42,211
Total U.S. Department of Justice		364,271,047

Department of Labor

Labor Force Statistics	17.002	8,039,223
Compensation and Working Conditions	17.005	850,200
Labor Certification for Alien Workers	17.203	3,665,954
Unemployment Insurance	17.225	5,274,682,163
Senior Community Service Employment Program	17.235	7,128,419
Trade Adjustment Assistance-Workers	17.245	25,263,585
Employment and Training Administration Pilots, Demonstrations, and Research Projects	17.261	680,557
Work Incentives Grant	17.266	2,018,931
Occupational Safety and Health-State Program	17.503	23,360,092
Consultation Agreements	17.504	6,147,595
Mine Health and Safety Grants	17.600	325,801
Disability Employment Policy Development	17.720	548,882
Veterans' Employment Program	17.802	453,258
Other-U.S. Department of Labor	17.999	1,677
Total Excluding Clusters		5,353,166,337
Employment Services Cluster		
Employment Service	17.207	95,140,636
Disabled Veterans' Outreach Program (DVOP)	17.801	12,842,130
Local Veterans' Employment Representative Program	17.804	7,287,079
Total Employment Services Cluster		115,269,845
WIA Cluster		
WIA Adult Program	17.258	137,766,338
WIA Youth Activities	17.259	141,922,744
WIA Dislocated Workers	17.260	192,828,387
Total WIA Cluster		472,517,469
Total U.S. Department of Labor		5,940,953,651

Department of Transportation

Boating Safety Financial Assistance	20.005	4,180,319
Airport Improvement Program	20.106	146,929
Motor Carrier Safety	20.217	10,458,171
National Motor Carrier Safety	20.218	24,334
Local Rail Freight Assistance	20.308	128,053
High Speed Ground Transportation-Next Generation High Speed Rail Program	20.312	838,508
Federal Transit - Metropolitan Planning Grants	20.505	42,849,833
Formula Grants for Other Than Urbanized Areas	20.509	17,411,440
Pipeline Safety	20.700	2,625,599
Interagency Hazardous Materials Public Sector Training and Planning Grants	20.703	433,331
Total Excluding Clusters		79,096,517

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Highway Planning and Construction Cluster			
Highway Planning and Construction	20.205	2,285,098,443	***
Federal Transit Cluster			
Federal Transit - Capital Investment Grants	20.500	6,984,218	
Highway Safety Cluster			
State and Community Highway Safety	20.600	37,887,482	
Alcohol Traffic Safety and Drunk Driving Prevention Incentive Grants	20.601	12,989,711	
Total Highway Safety Cluster		50,877,193	
Research and Development Cluster			
Highway Planning and Construction	20.205	13,180,287	
National Motor Carrier Safety	20.218	160,287	
Formula Grants for Other than Urbanized Areas	20.509	93,010	
State Planning and Research	20.515	1,307,505	
Total Research and Development Cluster		14,741,089	
Total U.S. Department of Transportation		2,436,797,460	
Equal Employment Opportunity Commission			
Employment Discrimination-State and Local Fair Employment Practices Agency Contracts	30.002	1,326,700	
General Services Administration			
Donation of Federal Surplus Personal Property	39.003	2,868,859	**
National Aeronautics and Space Administration			
Other-National Aeronautics and Space Administration	43.999	14,375	
National Foundation on the Arts and the Humanities			
Promotion of the Arts-State and Regional Program	45.007	987,100	
State Library Program	45.310	15,760,808	
Total National Foundation on the Arts and Humanities		16,747,908	
Department of Veterans Affairs			
Grants to States for Construction of State Home Facilities	64.005	6,549,344	
Veterans State Domiciliary Care	64.014	9,083,113	
Veterans State Nursing Home Care	64.015	11,365,398	
Veterans State Hospital Care	64.016	83,337	
Veterans Housing-Guaranteed and Insured Loans	64.114	48,799,355	****
All-Volunteer Force Educational Assistance	64.124	93,801	
Other-U.S. Department of Veterans Affairs	64.999	466,825	
Total U.S. Department of Veteran's Affairs		76,441,173	
Environmental Protection Agency			
Air Pollution Control Program Support	66.001	8,870,719	
State Indoor Radon Grants	66.032	120,779	
Water Pollution Control State and Interstate Program Support	66.419	5,058,470	
State Underground Water Source Protection	66.433	385,698	
Water Quality Management Planning	66.454	1,054,293	
National Estuary Program	66.456	230,491	
Capitalization Grants for Clean Water State Revolving Funds	66.458	70,123,537	
Nonpoint Source Implementation Grants	66.460	10,830,704	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Regional Wetland Program Development Grants	66.461	466,211
Water Quality Cooperative Agreements	66.463	594,384
Capitalization Grants for Drinking Water State Revolving Funds	66.468	93,567,339
Beach Monitoring and Notification Program Implementation Grants	66.472	530,830
Water Protection Grants to the States	66.474	122,471
Environmental Protection-Consolidated Research	66.500	276,096
Safe Drinking Water Research and Demonstration	66.506	2,439,759
Office of Research and Development Consolidated Research/Training	66.511	33,167
Surveys, Studies, Investigations and Special Purpose Grants	66.606	491,570
Environmental Information Exchange Network Grant Program and Related	66.608	11,286
Consolidated Pesticide Enforcement Cooperative Agreements	66.700	2,254,757
Toxic Substances Compliance Monitoring Cooperative Agreements	66.701	116,194
TSCA Title IV State Lead Grants Certification of Lead-Based Paint Professionals	66.707	480,697
Pollution Prevention Grants Program	66.708	81,503
Hazardous Waste Management State Program Support	66.801	7,436,643
Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements	66.802	845,976
State and Tribal Underground Storage Tanks Program	66.804	299,284
Leaking Underground Storage Tank Trust Fund Program	66.805	6,711,710
Solid Waste Management Assistance Grants	66.808	9,165
Superfund State and Indian Tribe Core Program Cooperative Agreements	66.809	137,389
State and Tribal Response Program Grants	66.817	1,121,463
Total Excluding Clusters		214,702,585
Research and Development Cluster		
Regional Wetland Program Development Grants	66.461	130,654
Pollution Prevention Grants Program	66.708	109,430
Pesticide Environmental Stewardship-Regional Grants	66.714	27,649
Surveys, Studies, Investigations, Training Demonstrations and Educational Outreach	66.716	21,099
Total Research and Development Cluster		288,832
Total U.S. Environmental Protection Agency		214,991,417
Office of State and Tribal Programs, Nuclear Regulatory Commission		
Radiation Control-Training Assistance and Advisory Counseling	77.001	87,906
Department of Energy		
State Energy Program	81.041	3,391,474
Weatherization Assistance for Low-Income Persons	81.042	6,015,657
Environmental Restoration	81.092	334,192
National Industrial Competitiveness through Energy, Environment, and Economics	81.105	46,828
Other - U.S. Department of Energy	81.999	427,268
Total Department of Energy		10,215,419
Federal Emergency Management Agency		
Community Assistance Program-State Support Services Element (CAP-SSSE)	83.105	292,508
State Disaster Preparedness Grants	83.505	79,479
Flood Mitigation Assistance	83.536	470,347

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Hazard Mitigation Grant	83.548	52,580
Emergency Management Performance Grants	83.552	748,552
Pre-Disaster Mitigation	83.557	422,560
State and Local All Hazards Emergency Operations Planning	83.562	1,142,141
Citizen Corps	83.564	1,071,293
Other - Federal Emergency Management Agency	83.999	1,179
Total Federal Emergency Management Agency		4,280,639

Department of Education

Adult Education-State Grant Program	84.002	108,602,142
Title I Grants to Local Educational Agencies	84.010	1,712,987,435
Migrant Education-State Grant Program	84.011	138,892,646
Title I Program for Neglected and Delinquent Children	84.013	4,884,969
Vocational Education-Basic Grants to States	84.048	135,127,232
Vocational Education-State Councils	84.053	347,100
Leveraging Educational Assistance Partnership	84.069	13,276,128
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	244,861,072
Rehabilitation Services-Service Projects	84.128	1,382,638
Independent Living-State Grants	84.169	1,873,182
Rehabilitation Services-Independent Living Services for Older Individuals Who are Blind	84.177	2,744,158
Special Education-Grants for Infants and Families with Disabilities	84.181	52,067,594
Safe and Drug-Free Schools and Communities-National Programs	84.184	6,684,106
Byrd Honors Scholarships	84.185	5,054,750
Safe and Drug-Free Schools and Communities-State Grants	84.186	61,295,496
Supported Employment Services for Individuals with Severe Disabilities	84.187	4,013,619
Education for Homeless Children and Youth	84.196	8,689,777
Even Start-State Educational Agencies	84.213	34,005,462
Fund for the Improvement of Education	84.215	449,240
Assistive Technology	84.224	683,930
Rehabilitation Services Demonstration and Training Programs	84.235	28,500
Tech-Prep Education	84.243	11,740,423
Rehabilitation Training-State Vocational Rehabilitation Unit In-Service Training	84.265	539,713
Eisenhower Professional Development State Grants	84.281	8,144,222
Charter Schools	84.282	16,586,467
Twenty-First Century Community Learning Centers	84.287	87,887,645
State Grants for Innovative Programs	84.298	37,416,920
Education Technology State Grants	84.318	77,598,372
Special Education-State Personnel Development	84.323	2,111,772
Advanced Placement Program	84.330	1,551,217
Grants to States for Incarcerated Youth Offenders	84.331	1,964,774
Comprehensive School Reform Demonstration	84.332	66,394,292
Teacher Quality Enhancement Grants	84.336	1,659
Title I Accountability Grants	84.348	2,733,423
Transition to Teaching	84.350	263
School Renovation Grants	84.352	134,974
Reading First State Grants	84.357	158,552,833
Rural Education	84.358	1,421,127
Literacy Through School Libraries	84.364	69,075
English Language Acquisition Grants	84.365	157,846,262
Mathematics and Science Partnerships	84.366	12,196,633
Improving Teacher Quality State Grants	84.367	336,366,232

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Grants for State Assessments and Related Activities	84.369	57,768,000	
Total Excluding Clusters		3,576,977,474	
Student Financial Aid Cluster			
Federal Family Education Loans	84.032	24,965,036,404	***
Special Education Cluster			
Special Education - Grants to States	84.027	964,211,655	
Special Education - Preschool Grants	84.173	37,437,044	
Total Special Education Cluster		1,001,648,699	
Total U.S. Department of Education		29,543,662,577	
Election Assistance Commission			
Help America Vote Act Requirements Payments	90.401	169,677,955	
Department of Health and Human Services			
Public Health and Social Services Emergency Fund	93.003	11,597,522	
Special Programs for the Aging-Title VII, Chapter 3, Programs for Prevention of Elder Abuse, Neglect, and Exploitation	93.041	527,692	
Special Programs for the Aging-Title VII, Chapter 2-Long Term Care Ombudsman Services for Older Individuals	93.042	1,655,047	
Special Programs for the Aging-Title III, Part D-Disease Prevention and Health Promotion Services	93.043	1,492,634	
Special Programs for the Aging - Title IV and Title II - Discretionary Projects	93.048	233,716	
National Family Caregiver Support	93.052	17,291,878	
Food and Drug Administration-Research	93.103	1,117,311	
Maternal and Child Health Federal Consolidated Programs	93.110	324,312	
Biological Response to Environmental Health Hazards	93.113	26,502	
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	8,040,635	
Emergency Medical Services for Children	93.127	109,518	
Primary Care Services Resource Coordination and Development	93.130	249,463	
Injury Prevention and Control Research and State and Community Based Programs	93.136	4,051,954	
Projects for Assistance in Transition from Homelessness (PATH)	93.150	6,485,977	
Health Program for Toxic Substances and Disease Registry	93.161	687,903	
Grants to States for Loan Repayment Program	93.165	652,443	
Disabilities Prevention	93.184	325,675	
Consolidated Knowledge Development and Application (KD&A) Program	93.230	2,227,917	
Cooperative Agreements for State Treatment Outcomes and Performance Pilot Studies Enhancement	93.238	131,612	
State Rural Hospital Flexibility Program	93.241	352,587	
Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	1,014,566	
Universal Newborn Hearing Screening	93.251	122,964	
Rural Access to Emergency Devices Grant	93.259	179,081	
Immunization Grants	93.268	190,191,276	*
Substance Abuse and Mental Health Services - Access to Recovery	93.275	310,954	
Centers for Disease Control and Prevention-Investigations and Technical Assistance	93.283	86,597,476	^
Small Rural Hospital Improvement Grant Program	93.301	1,116,886	
Promoting Safe and Stable Families	93.556	64,792,491	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Temporary Assistance for Needy Families	93.558	3,287,344,893
Child Support Enforcement	93.563	466,358,441
Child Support Enforcement Research	93.564	25,498
Refugee and Entrant Assistance-State Administered Programs	93.566	24,497,821
Low-Income Home Energy Assistance	93.568	89,196,390
Community Services Block Grant	93.569	57,134,922
Community Services Block Grant Formula and Discretionary Awards Community Food and Nutrition Programs	93.571	552,245
Refugee and Entrant Assistance-Discretionary Grants	93.576	2,839,056
U.S. Repatriation	93.579	32,810
Refugee and Entrant Assistance-Targeted Assistance Grants	93.584	4,873,848
Empowerment Zones Program	93.585	758,577
State Court Improvement Program	93.586	1,259,895
Community-Based Child Abuse Prevention Grants	93.590	2,336,845
Welfare Reform Research, Evaluations and National Studies	93.595	106
Grants to States for Access and Visitation Programs	93.597	952,329
Chafee Education and Training Vouchers Program (ETV)	93.599	14,349,850
Head Start	93.600	254,754
Adoption Incentive Payments	93.603	753,895
Mentoring Children of Prisoners	93.616	44,076
Developmental Disabilities Basic Support and Advocacy Grants	93.630	6,550,000
Children's Justice Grants to States	93.643	1,950,558
Child Welfare Services-State Grants	93.645	31,193,235
Social Services Research and Demonstration	93.647	204,503
Adoption Opportunities	93.652	384,697
Foster Care-Title IV-E	93.658	1,309,966,783
Adoption Assistance	93.659	307,409,191
Social Services Block Grant	93.667	284,090,384
Child Abuse and Neglect State Grants	93.669	3,289,560
Family Violence Prevention and Services/Grants for Battered Women's Shelters - Grants to States and Indian Tribes	93.671	10,791,104
Chafee Foster Care Independence Program	93.674	22,203,985
State Children's Insurance Program	93.767	713,302,558
Medicaid Infrastructure Grants To Support the Competitive Employment of People with Disabilities	93.768	83,932
Medicare-Supplementary Medical Insurance	93.774	3,645,107
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations	93.779	2,334,929
Grants to States for Operation of Offices of Rural Health	93.913	195,814
HIV Care Formula Grants	93.917	122,731,768
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938	714,842
HIV Prevention Activities - Health Department Based	93.940	11,286,927
HIV Demonstration, Research, Public and Professional Education Projects	93.941	943,745
Epidemiologic Research Studies of Acquired Immunodeficiency Syndrome (AIDS) and Human Immunodeficiency Virus (HIV) Infection in Selected Population Groups	93.943	595,340
Human Immunodeficiency Virus (HIV)/Acquired Immuno-deficiency Virus Syndrome (AIDS) Surveillance	93.944	3,245,219
Tuberculosis Demonstration, Research, Public and Professional Education	93.947	231,229
Trauma Care Systems Planning and Development	93.952	35,532
Block Grants for Community Mental Health Services	93.958	54,508,860
Block Grants for Prevention and Treatment of Substance Abuse	93.959	252,728,838

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Preventive Health Services-Sexually Transmitted Diseases Control Grants	93.977	6,864,791
Preventive Health Services- Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	93.978	1,585,710
Mental Health Disaster Assistance and Emergency Mental Health	93.982	2,715,713
Health Programs for Refugees	93.987	410,791
Cooperative Agreements for State-Based Diabetes Control Programs and Evaluation of Surveillance Systems	93.988	1,768,678
Preventive Health and Health Services Block Grant	93.991	9,260,988
Maternal and Child Health Services Block Grant to the States	93.994	40,826,785
Other-Department of Health and Human Services	93.999	13,066,765
Total Excluding Clusters		7,576,593,104
Aging Cluster		
Special Programs for the Aging - Title III, Part B - Grants for Supportive Services and Senior Centers	93.044	34,978,214
Special Programs for the Aging - Title III, Part C - Nutrition Services	93.045	51,050,564
Nutrition Services Incentive Program	93.053	13,151,469
Total Aging Cluster		99,180,247
Child Care Cluster:		
Child Care and Development Block Grant	93.575	572,432,961
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596	235,541,435
Total Child Care Cluster		807,974,396
Medicaid Cluster		
State Medicaid Fraud Control Units	93.775	18,250,877
State Survey and Certification of Health Care Providers and Suppliers	93.777	28,729,236
Medical Assistance Program	93.778	18,292,201,374
Total Medicaid Cluster		18,339,181,487
Research and Development Cluster		
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	404,203
Consolidated Knowledge Development and Application (KD&A) Program	93.230	101,980
Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	126,528
Preventive Health Services-Sexually Transmitted Diseases Control Grants	93.977	176,398
Total Research and Development Cluster		809,109
Total U.S. Department of Health and Human Services		26,823,738,343

Corporation for National and Community Service

CalServ America	94.001	80,923
State Commissions	94.003	1,455,794
Learn and Serve America-School and Community Based Programs	94.004	2,252,080
AmeriCorps	94.006	20,892,473
Total Excluding Clusters		24,681,270

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Foster Grandparent/Senior Companion Cluster		
Foster Grandparent Program	94.011	1,537,847
Total U.S. Corporation for National and Community Service		26,219,117
Social Security Administration		
Disability Insurance/SSI Cluster		
Social Security-Disability Insurance	96.001	190,623,811
Department of Homeland Security		
State Domestic Preparedness Equipment Support Program	97.004	12,704,453
Urban Areas Security Initiative	97.008	16,897,334
State Access to the Oil Spill Liability Trust Fund	97.013	25,000
Pre-Disaster Mitigation (PDM) Competitive Grants	97.017	1,221,397
Crisis Counseling	97.032	139,950
Disaster Unemployment Assistance	97.034	205,187
Public Assistance Grants	97.036	399,020,072
Hazard Mitigation Grant	97.039	65,398,374
Emergency Management Performance Grants	97.042	9,578,581
Cooperating Technical Partners	97.045	230,473
Fire Management Assistance Grant	97.046	28,093,440
Map Modernization Management Support	97.070	20,338
Total Department of Homeland Security		533,534,599
Office of National Drug Control Policy		
High Intensity Drug Trafficking Area	See Note 4	4,767,940
Miscellaneous Grants and Contracts		
Shared Revenue-Flood Control Lands	99.002	108,975
Shared Revenue-Grazing Land	99.004	115,126
U.S. Department of the Interior-Fire Prevention/Suppression Agreement	99.014	634,000
U.S. Department of the Interior-Fire Prevention/Suppression Agreement	99.015	238,766
U.S. Department of Agriculture and Various Other U.S. Department-Fire Prevention/Suppression	99.016	52,118,030
Miscellaneous Federal Receipts	99.099	455,702
Miscellaneous Federal Receipts	99.999	2,002,537
Total Miscellaneous		55,673,136
Total Federal Awards Received		71,897,824,318

* Amount includes value of commodities or food stamps.
** Amount includes donated property.
*** Amount includes loans in effect as of June 30, 2005.
**** Amount includes insurance in effect as of June 30, 2005.
^ Amount consists of several programs, including $77,111,164 for the Public Health Preparedness and Response for Bioterrorism program and $8,132,207 for the Breast and Cervical Cancer Control program.

NOTES TO THE SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2005

1. GENERAL

The accompanying State of California Schedule of Federal Assistance presents the total amount of federal financial assistance programs received by the State of California for the fiscal year ended June 30, 2005. This schedule does not include expenditures of federal grants received by the University of California, the California State University, and the California Housing Finance Agency. The expenditures of the University of California, California State University, and California Housing Finance Agency are audited by other independent auditors in accordance with the U.S. Office of Management and Budget, Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133).

The $71,897,824,318 in total federal assistance consists of the following:

Cash assistance received	$44,248,872,350
Noncash federal awards	2,577,857,859
Loans and/or loan guarantees outstanding	25,022,294,754
Insurance in-force	48,799,355
Total	$71,897,824,318

2. BASIS OF ACCOUNTING

OMB Circular A-133 and the Single Audit Act of 1984 (Amended 1996) require the Schedule of Federal Assistance to present total expenditures for each federal assistance program. However, although the state accounting system separately identifies revenues for each federal assistance program, it does not separately identify expenditures for each program. As a result, the State prepares its Schedule of Federal Assistance on a cash receipts basis. The schedule shows the amount of cash and non-cash federal assistance received, loans and loan guarantees outstanding, and insurance in force for the year ended June 30, 2005.

3. UNEMPLOYMENT INSURANCE

Of the $5,274,682,163 in total unemployment insurance funds (federal catalog number 17.225) received by the Employment Development Department during fiscal year 2004-05, $4,905,266,962 was State Unemployment Insurance funds that were drawn down from the Unemployment Trust Fund in the U.S. Treasury.

4. OTHER

The California Department of Justice (DOJ) receives cash reimbursements from local law enforcement agencies under the Office of National Drug Control Policy's High Intensity Drug Trafficking Area program. During the period July 1, 2004 through June 30, 2005, the DOJ received the following cash reimbursements from pass-through entities:

Federal Agency/Program	Pass-through Entity	Grant Number	Amount
Office of National Drug Control Policy High Intensity Drug Trafficking Area			
	LA Clear/LA Police Chief's Association/City of Hawthorne	I4PLAP534	$ 907,779
	NC HIDTA/LA Police Chief's Association/San Mateo County	I4PLAP534	125,930
	CV HIDTA/LA Police Chief's Association/Stanislaus County	I4PLAP534	89,102
	INCH/LA Police Chief's Association/Riverside County	I4PLAP534	57,997
	INCH/LA Police Chief's Association/Riverside County	I5PLAP534	5,844
	NV HIDTA/LA Police Chief's Association/Las Vegas Metro PD	I3PNVP501Z	136,057
	CA Border Alliance Group/ City of San Diego	I2PSCP575	1,367
	CA Border Alliance Group/ City of San Diego	I3PSCP575	151,214
	CA Border Alliance Group/ City of San Diego	I4PSCP575	1,650,508
	CA Border Alliance Group/ City of San Diego	I5PSCP575	285,870
	Northwest HIDTA/Washington State	I3PNWP505	7,750
	Northwest HIDTA/Washington State	I4PNWP505	38,750
	Clallaum Co Sheriff's Office	2001CKWX0177	25,497
	Clallaum Co Sheriff's Office	2004CKWX0034	22,496
	Criminal Information Sharing Alliance	DCA1000310001	1,140,780
	Institute of Intergovernmental Research	2003RSCX1002	120,999
		Total	$4,767,940

The State was also loaned Federal Excess Personal Property (FEPP) from the U.S. Forest Service during the period July 1, 2004 to June 30, 2005. According to the California Department of Forestry and Fire Protection, the amount loaned from July 1, 2004 to June 30, 2005, was $6,199,449. The U.S. Forest Service and the State maintain the FEPP program at federal acquisition costs of the property.

Summary Schedule of Prior Audit Findings

Prepared by
Department of Finance

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

Reference Number:	**2004-12-1**
Federal Program:	All Programs
State Administering Department:	Department of Finance
Fiscal Year Initially Reported:	1995-96
Audit Finding:	Reporting. Because of limitations in its automated accounting systems, the State has not complied with the provision of OMB Circular A-133 requiring a schedule showing total expenditures for each federal program.
Status of Corrective Action:	Remains uncorrected. The State's accounting system will require substantial modification to comply with federal and State requirements. Given the State's current limited resources, the Department of Finance has no plans at this time to enhance the State's accounting system or to implement a new system.[1]

Reference Number:	**2004-3-12**
Federal Program:	10.568
State Administering Department:	Department of Social Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. The Department of Social Services did not always limit cash transfers of federal funds to the minimum amounts needed for the Emergency Food Assistance Program.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-13-2**
Federal Program:	10.558
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03

Audit Finding:	Subrecipient Monitoring. The Department of Education did not adequately fulfill its subrecipient monitoring responsibilities for the food program.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-13-7**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Subrecipient Monitoring. Health Services did not always promptly receive all audit reports from its non-profit subrecipients.
Status of Corrective Action:	Remains uncorrected/Agree with finding. The WIC Branch has recently undergone significant restructuring in the areas of local agency support and fiscal management. This restructuring will allow for more complete and timely audit tracking and responses; however, given that the restructure is new, the processes have not been developed. We expect to be able to develop and implement the new process so that it is fully operational in the next six months.

Reference Number:	**2004-13-10**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. In fiscal year 2002-03, it was reported that the Department of Health Services did not comply with its internal policy requiring it to issue letters of findings to the local agencies within 60 days of the exit conferences. We recommended that the Health Services comply with its internal policy; we also recommended that if Health Services believes this deadline is too restrictive, it should consider revising its internal policy. However, rather than revising the policy and establishing a more

reasonable deadline, Health Services eliminated the 60-day deadline from its internal policies.

Based on our review, we found delays in the Health Services' notification process. As a result, Health Services cannot always ensure that its subrecipients correct deficiencies promptly.

Status of Corrective Action: Remains uncorrected/Disagree with finding. DHS continues to disagree with this finding; however, in the past year, procedures have been changed and a much smaller percentage of Program Evaluation letter of findings are issued to local agencies past 90 days from the exit conference.

Remains uncorrected/Agree with finding. State staff will be trained to contact each local agency at least two weeks before a corrective action plan is due to remind each local agency to submit the corrective action plan in a timely manner. This procedure will be added to the State staff procedure training manual and discussed at staff meetings to assure consistency.[2]

Reference Number: **2004-13-15**

Federal Program: 10.551, 10.561

State Administering Department: Department of Social Services

Fiscal Year Initially Reported: 2003-04

Audit Finding: Subrecipient Monitoring. Social Services is not fulfilling all its monitoring responsibilities for the Food Stamps programs. For federal fiscal year 2003-04, although Social Services performed the required annual program reviews of seven large counties, it did not conduct any of the claims management reviews and two of the civil rights reviews required for those counties. Because it is not conducting annual reviews of the large project areas as required by the federal regulations, Social Services has less assurance that subrecipients are complying with applicable laws and regulations.

Status of Corrective Action: Fully corrected.

Reference Number:	**2004-13-12**
Federal Program:	14.239
State Administering Department:	Housing and Community Development
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Subrecipient Monitoring. Housing and Community Development lacks an adequate system to ensure that it promptly receives all audit reports from non-profit subrecipients required to submit them. It also lacks an adequate system to ensure that it issues management decisions on reported findings.
Status of Corrective Action:	Fully Corrected.

Reference Number:	**2004-1-4**
Federal Program:	16.575
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Activities Allowed, Allowable Costs, Cash Management, Eligibility, Period of Availability, Reporting. Office of Emergency Services (OES) cannot ensure that all fiscal year 2003-04 expenditure and revenue transactions applicable to the Crime Victim Assistance program grants awarded for federal fiscal years 2000, 2001, and 2002 were recorded in the accounting records. As a result, OES cannot determine whether the federal financial status reports submitted for these grants are accurate. Moreover, because of the uncertainty of the completeness of OES's accounting records, we could not be sure that we subjected all transactions related to these grants to testing. Consequently, we are unable to conclude that OES, or the former Office of Criminal Justice Planning (OCJP), which administered the grants until it closed in December 2003, complied with federal laws, regulations, and requirements for activities allowed, allowable costs, cash management, eligibility, period of availability, and reporting.

Status of Corrective Action:	Remains uncorrected/Agree with finding. This statement is accurate and the financial condition of the previous OCJP (Agency 8100) remains unchanged as of this time. A lack of adequate resources, specifically additional staff to meet the needs of the additional workloads presented by the inheritance of OCJP, is now being addressed by OES executive management and it is our hope that all necessary positions will be filled by January 31, 2006. With the additional positions now authorized, OES accounting staff can begin the reconstruction of the OCJP records, including but not limited to those items identified in the Office of State Audits and Evaluations' reconstruction report. It is anticipated that this project will require three to four full-time staff three to four months to complete.[3]

Reference Number:	**2004-13-9**
Federal Program:	16.575, 16.007, 97.036 (formerly 83.544), 97.039 (formerly 83.548)
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Subrecipient Monitoring. The Office of Emergency Services (OES) did not adequately monitor subrecipients of funds for the Crime Victim Assistance, State Homeland Security Grant, Public Assistance Grants, and Hazard Mitigation Grant programs.
Status of Corrective Action:	Part 1: OES does not perform all pass-through agency requirements of OMB Circular A-133. Remains uncorrected/Agree with finding. OES agrees that it did not fully comply with all pass-through agency requirements included in OMB Circular A-133. OES did not fully comply because it lacked adequate staffing levels to perform all required work. When OES has adequate staff to perform all required work, OES will fully comply with all OMB Circular A-133 subrecipient monitoring requirements. The State Office of Homeland Security (OHS) is now responsible for all pass-through agency responsibilities related to homeland security grants.

Following is OHS' description of their current process for OMB Circular A-133 subrecipient monitoring:

At this time, audit reports are being sent directly to the Grants Monitoring Unit (GMU) of OHS. Prior to an on-site monitoring visit, a Program Monitor (PM) is required to determine if any audits have come in, applicable to the sub-grantee being monitored; and if necessary, incorporate in the monitoring field document any findings noted by the auditor. It should also be noted that this process of a pre-visit desk review of audit reports is an on-going day-to-day duty assignment of the GMU. During a monitoring visit, it is incumbent upon the PM to ensure that any audit findings have been addressed. If needed, the PM will address the findings in the required Corrective Action Plan. Prior to closing out an OHS grant, the sub-recipient is required to seek verification by the GMU of compliance with any corrective actions noted.

Part 2: OES does not adequately follow up on the results of site visits it conducts.

Partially corrected. Immediately after the Victim Services Branch manager received notification from the Bureau of State Audits (BSA) of the finding in November 2004, the following corrective action was taken:

First, although the former Office of Criminal Justice Planning (OCJP) had a Grants Management Information System (GMIS) that tracked the date of site visits, it did not track satisfactory resolution of deficiencies that were identified during site visits. Adding this element to GMIS would have been an easy fix; however, after OCJP was abolished effective January 1, 2004 and became a division under OES, GMIS was no longer maintained. As a result, the Branch developed a new tracking process through an Excel spreadsheet as a management information tool. Staff were to enter and update site visit information for fiscal year 2004-05 for each grant recipient on the spreadsheet. Once the BSA finding regarding site visits surfaced, the following items were added to the Excel spreadsheet for tracking purposes: Last Site Visit, Form Completed, Corrective Action Plan Status, Scheduled Visits, and Last Monitoring.

Second, managers developed or revised independent methods of tracking and managing information within their Section regarding site visits, some of which were more detailed than the Branch spreadsheet. For instance, one Section developed a form entitled, "Site Visit Report Check List" which tracks the following information: grantee, site visit date, letter sent to grantee, report given to section chief, correction action plan due date, corrective action received approved, and reminder contact. It should be noted that the Victim Services Branch intends to consolidate the independent methods each Section is using into one working document and process for consistency purposes, and staff from each Section are coordinating this effort.

Third, as a consequence of Senate Bill 914 (added by Stats. 2004, Ch. 840), and codified as Penal Code Sections 13823.15, 13823.16, and 13837.1, Staff Instructions were developed for Domestic Violence Assistance and Rape Crisis Programs regarding site visits. The instructions include all phases of the visit, from preparing to summarizing corrective actions required. The Staff Instructions also provide information on follow-up and satisfactory completion of corrective action in which within 30 days of satisfactory completion, a letter is sent to the grant recipient indicating the project is in full compliance with all program requirements, and a copy is sent to the OES Grant File. Additionally, the Staff Instructions provide a format for the corrective action letter which includes three components for each finding, i.e. Finding, Citation, and Corrective Action.

These staff instructions and accompanying site visit forms are in draft format, but have been reviewed by OES Legal Counsel. The Domestic Violence and Sexual Assault Sections have pilot tested them during site visits and the forms are being slightly revised. It is anticipated that final versions will be approved by March 2006. Should the forms be successful, it is anticipated they may be used for all of the programs in the Branch in the future.

Finally, despite the tools mentioned above, OES continues to have problems with adequately following up and documenting the results of site visits conducted. Although mechanisms are in place, the Victim Services Branch was staffed at approximately 70 percent capacity due to first a

hiring freeze, and then a pause in hiring. Since the Branch was short staffed and had varying competing priorities, proper documentation and follow up with respect to site visits was sometimes neglected. This issue is currently being resolved as the Victim Services Branch is in the process of hiring staff, although staff retention has also become a new concern.[4]

Reference Number:	**2004-2-1**
Federal Program:	17.207, 17.801, 17.804, 17.225, 17.258, 17.259, 17.260
State Administering Department:	Employment Development Department
Fiscal Year Initially Reported:	1998-99
Audit Finding:	Allowable Costs and Cost Principles. EDD allocated six of ten operating expense and equipment (OE&E) transactions we reviewed, even though it had not obtained federal approval to do so as part of its indirect cost rate proposal. According to EDD, it used the allocation codes to distribute OE&E costs that it could not specifically identify with a particular federal program. Consequently, EDD should have included and distributed these allocated costs under its indirect cost rate proposal.
Status of Corrective Action:	Partially corrected. The EDD submitted the Indirect Cost Rate Proposal (ICRP) for the period beginning on July 1, 2005 to the Department of Labor, Office of Cost Determination (OCD) on June 30, 2005. The ICRP describes all cost pools that the EDD began using starting July 1, 2005. The use of cost pools will eliminate the need for 151 allocation codes. The ICRP explains how costs will be distributed to programs in accordance with benefits received per Office of Management and Budget Circular A-87. The EDD has also recently met with the OCD Cost Negotiator. The OCD Cost Negotiator agreed with the basis for most of the EDD's cost pool allocations, and only identified two areas of concern. The EDD will be revising the ICRP submission and will be providing additional data to the OCD by December 30, 2005.[5]

Reference Number:	**2004-9-1**
Federal Program:	17.207, 17.801, 17.804, 17.225, 17.258, 17.259, 17.260
State Administering Department:	Employment Development Department
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Procurement. EDD does not appropriately review invoices for purchases of airline tickets.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-9-2**
Federal Program:	20.205
State Administering Department:	Department of Transportation
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Suspension and Debarment. Although the California Department of Transportation required its private contractors to submit suspension and debarment certifications, it did not require its subrecipients (local governments) to submit such certifications.
Status of Corrective Action:	Fully corrected.[6]

Reference Number:	**2004-9-3**
Federal Program:	20.505
State Administering Department:	California Department of Transportation
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Suspension and Debarment. Although the California Department of Transportation states in its guidance to subrecipients of the planning grants program that subrecipients must submit suspension and debarment certifications, Caltrans did not always have suspension and debarment certifications from its subrecipients.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-1-3**
Federal Program:	39.011
State Administering Department:	Office of the Secretary of State
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Activities Allowed, Allowable Costs, Procurement, and Suspension and Debarment. The Office of the Secretary of State (Office) overrode and, in many cases, lacked adequate controls to ensure that it appropriately administered HAVA funds designated to improve the administration of federal elections (discretionary funds). It was found that the Office lacked support for the personal service costs it charged to HAVA. In addition, its poor oversight of consultants and consultant contracts also resulted in questionable costs. Moreover, the Office used questionable practices to procure goods and services funded with discretionary funds. Finally, the Office did not obtain the required suspension and debarment certifications from vendors with procurement contracts of $100,000 or more that were paid with discretionary funds from subrecipients who received HAVA funds to replace voting machines.
Status of Corrective Action:	Ensure time charged is supported by appropriate documentation: Fully corrected. Follow Control Procedures: Partially corrected. Comprehensive procedures were developed for contracting activities. Included in these processes is a more efficient contract review process, which requires every contract to include a detailed scope of work, specific deliverables, and performance measures. Additional training for new and existing staff in this new process will take place prior to June 30, 2006. Require contract managers monitor for completion of contract services and work products prior to approving invoices for payment: Fully corrected

	Review invoices to assure that charges to be paid with HAVA funds are reasonable and allowable, and conform to the terms of the contract: Fully corrected. Follow competitive bidding requirements: Fully corrected. Follow General Services' policies when using CMAS for contracting needs: Fully corrected. Comply with state policy for procuring commodities: Fully corrected. Ensure subrecipients and applicable vendors are not suspended or debarred from doing business with federal government: Fully corrected.[7]

Reference Number:	**2004-3-1**
Federal Program:	84.357
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that Reading First subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds.
Status of Correction Action:	Fully corrected.

Reference Number:	**2004-3-2**
Federal Program:	84.002
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that Adult Education program subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds.

Status of Corrective Action:	Partially corrected. Education implemented a process requiring agencies to submit mid-year and year-end expenditure reports. Education releases its first payment of 50 percent to the agencies, and later requests the agencies to submit a mid-year expenditure report. If on the mid-year expenditure report, the agency expends more than 80 percent, it will receive a second payment of 25 percent, otherwise it will receive 12.5 percent. Education will include on the mid-year report a certification by the agency that they have not received $100 in interest.

Reference Number:	**2004-3-3**
Federal Program:	84.010
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that Title I, Part A subrecipients, which are all Local Educational Agencies (LEA), demonstrate the ability to minimize the time between receipt and disbursement of federal funds.
Status of Corrective Action:	Partially corrected. Education continues to allocate funds proportionate to the unpaid months that have elapsed prior to and including the month the current apportionment, based on the principle that LEAs incur federal expenditures fairly constantly through the year. Education included language in apportionment letters to notify LEAs of a potential delay in funding if significant carry over balances existed. Furthermore, the Title I program office monitors the percentage of carryover balances as submitted on Part I of the Consolidated Application. When an LEA is over their 15 percent carry over limit, a waiver is requested from the program office. Program staff review/approve and notify fiscal staff if funds should be withheld. Education refined its process to ensure the State Board approves all LEA plans prior to the disbursement of federal funds. A file of the Consolidated Application Title I participants is compared to a listing of active schools to ensure

	those applying to participate in Title I funds are operating. When an LEA plan is received, it is reviewed to ensure that all the information is present, then it is forwarded to the State Board for approval. The calculations of the entitlement are completed, but no funds are released into the apportionment until a State Board approved LEA plan is verified against the Consolidated Application and active schools listing. Education also verifies that there is a State Board approved LEA plan before apportionments are released.[8]

Reference Number:	**2004-3-4**
Federal Program:	84.243
State Administering Department:	California Community Colleges, Chancellor's Office
Fiscal Year Initially Reported:	1997-98
Audit Finding:	Cash Management. The California Community Colleges, Chancellor's Office (Chancellor's Office) does not have adequate procedures to ensure that Tech-Prep subrecipients minimize the time between receipt and disbursement of federal funds.
Status of Corrective Action:	Partially corrected. Based on the recommendations and findings, the Chancellor's Office continues to work to align cash disbursements with expenditure levels. To avoid excess cash draw downs of the Perkins Act funding, the Chancellor's Office analyzes prior year expenditures to determine the Advance Apportionment, and the current year quarterly expenditures to determine the First Principal Apportionment (P1), and the Second Principal Apportionment (P2). If justified, we are holding back more funds at Advance Apportionment to avoid excess cash. We will continue to monitor the situation throughout the year to determine whether the problem is fixed. Therefore, the status of the findings are partially corrected, with anticipated correction date of June 30, 2006.

Reference Number:	**2004-3-5**
Federal Program:	84.027, 84.173
State Administering Department:	Department of Education

Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time between receipt and use of federal funds.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-3-6**
Federal Program:	84.318
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that Education Technology subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal program funds.
Status of Corrective Action:	Remains uncorrected/Agree with finding. With almost 1,000 potential Education Technology subrecipients and over 500 grant awards under $10,000, Education continues to explore methods for an optimal monitoring approach. However, a reimbursement system places an undue burden on the LEAs and Education, as significant additional paperwork processing would be required for amounts that are needed upfront to purchase technology. We continue to monitor and bill LEAs at the end of the grant period through the end of period expenditure review process.[9]

Reference Number:	**2004-3-7**
Federal Program:	84.367
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that

	subrecipients of the Improving Teacher Quality program demonstrate the ability to minimize the time between receipt and disbursement of federal funds.
Status of Corrective Action:	Fully corrected.[10]

Reference Number:	**2004-3-8**
Federal Program:	84.365
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that the English Language Acquisition Grant subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds.
Status of Corrective Action:	Fully corrected.[11]

Reference Number:	**2004-3-9**
Federal Program:	84.298
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. The Department of Education does not have adequate procedures to ensure that subrecipients of the Innovative Education program minimize the time between receipt and disbursement of federal funds.
Status of Corrective Action:	Partially corrected. Education implemented revisions to the Consolidated Application to capture LEA expenditure data. The fiscal and program offices are working together to establish a procedure to use the expenditure data prior to releasing subsequent funds.[12]

Reference Number:	**2004-3-11**
Federal Program:	84.048
State Administering Department:	California Community Colleges, Chancellor's Office
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Cash Management. The Chancellor's Office did not always withhold a subrecipient's last payment until the Chancellor's Office received and reviewed the subrecipient's final expenditure report for the fiscal year.
Status of Corrective Action:	Partially corrected. Based on the recommendations and findings, the Chancellor's Office has worked to ensure approval of final expenditure reports before release of final payments. We also discerned between: (1) those reports which are approvable for payment purposes, and (2) those reports we hold open for resolution of immaterial, clerical issues, such as inconsistencies in tallies of activities. This year, we also have a later date for certification of apportionment recalculation, which should further lessen the opportunities for this type of audit exception. We believe the finding is fully corrected as of December 9, 2005, the date of recalculation of fiscal year 2004-05 funding.

Reference Number:	**2004-5-1**
Federal Program:	84.126
State Administering Department:	Department of Rehabilitation
Fiscal Year Initially Reported:	1996-97
Audit Finding:	Eligibility. The Department of Rehabilitation does not always determine applicant eligibility for Vocational Rehabilitation services within the required period.
Status of Corrective Action:	Partially corrected. The Department agrees with this finding, and continues its efforts to improve in making timely eligibility determinations through field staff performance management. The overall percentage of overdue eligibility determinations has continued to decrease statewide. A significant and steady decline

over time indicates that corrective actions taken to date have been effective in increasing compliance in this area.

EPS – Employment Preparation Services Centralized Services has implemented a pilot case review project designed to provide management with information and resources to further support making timely eligibility determinations, as well as other crucial case management and recording requirements.

BFS – Given that the Department's most current overdue eligibility data indicates a relatively high number of overdue eligibility determinations made in the Specialized Services Blind Field Service Division, a targeted corrective action plan has been developed by the Specialized Services Division Deputy Director.[13]

Reference Number:	**2004-7-1**
Federal Program:	84.298
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Earmarking. The Department of Education does not have adequate procedures to ensure that it meets the Innovative Education program earmarking requirements. Thus, it cannot ensure that it spends federal funds in compliance with federal regulations.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-7-2**
Federal Program:	84.010, 84.048, 84.298, 84.365, 84.367
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Level of Effort – Supplement Not Supplant . The Department of Education does not have a system in place for monitoring the State's compliance with the requirement that it use revenues from certain federal

	grants to supplement, rather than supplant, existing funds for grant-related activities.
Status of Corrective Action:	Partially corrected. Education program offices for Title I, Title III, and Vocational Education have determined the specific supplement requirements for its particular program, and worked with fiscal staff to track and monitor state and local expenditures and state appropriations, as necessary, for compliance with the requirements. By December 2005, Education will complete the process for the Title II and Title V programs. Furthermore, for Title III, Education included in its Categorical Program Monitoring review instrument, a supplement not supplant section. Education educated field monitoring staff in its use, and now it is an element of active on-site review.[14]

Reference Number:	**2004-7-3**
Federal Program:	84.027
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Level of Effort – Maintenance of Effort . The Department of Education does not have a system in place to demonstrate that the State maintains funding for Special Education and related services at a level that is at least equal to the funding for the prior year.
Status of Corrective Action:	Fully corrected.[15]

Reference Number:	**2004-9-4**
Federal Program:	84.126
State Administering Department:	Department of Rehabilitation
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Suspension and Debarment. The Department of Rehabilitation did not obtain the required suspension and debarment certification from three of the four contractors we reviewed that had amendments to

existing contracts or new contracts initiated during fiscal year 2003-04.

Status of Corrective Action: Fully corrected.

Reference Number: **2004-13-3**

Federal Program: 84.048, 84.318

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2003-04

Audit Finding: Subrecipient Monitoring. The Department of Education did not adequately fulfill its subrecipient monitoring responsibilities for Vocational Education and Education Technology.

Status of Corrective Action: Fully corrected.

Reference Number: **2004-13-4**

Federal Program: 84.010

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2002-03

Audit Finding: Subrecipient Monitoring. The Department of Education has not monitored whether LEAs receiving Title I, Part A funds have complied with the requirement to provide school services that are at least comparable to services provided by schools not receiving these federal funds.

Status of Corrective Action: Fully corrected.

Reference Number: **2004-13-5**

Federal Program: 84.027, 84.173

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2003-04

Audit Finding: Subrecipient Monitoring. Education does not monitor the activities of its subrecipients awarded funds from

	the Special Education-Grants to States program and the Special Education-Preschool Grants program in accordance with grant award eligibility documents.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-14-3**
Federal Program:	84.032
State Administering Department:	California Student Aid Commission
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Special Tests and Provisions. The Commission's auxiliary organization administers the loan program. However, the auxiliary organization has not developed adequate internal controls over its information systems to provide reasonable assurance that it keeps current, complete, and accurate records of each loan.
Status of Corrective Action:	Comprehensive Security Risk Assessment and Entity-wide Security Program Plan. Partially corrected. An external consulting firm was contracted to perform a comprehensive information security risk assessment. The final report was issued on June 16, 2005. Based on the information security risk assessment, the Commission and the auxiliary are in the process of developing an entity-wide security program plan, which will describe the organization's security program and the related policies and procedures. The plan is expected to be completed by the end of the auxiliary's fiscal year, which is September 30, 2006. Information Security Officer. Fully corrected. Computer Room Monitoring. Fully corrected. Removal of Employee Electronic Access. Fully corrected. Segregation of Duties. Fully corrected. Preventative Controls. Fully corrected. Data and Table Maintenance. The auxiliary performed the following activities regarding data

maintenance during the State fiscal year ended June 30, 2005:

1. Inventory the key data maintenance changes.
2. Determine the cause(s) and criticality of such changes.
3. Determine the volume of such changes and associated risk(s).

The auxiliary felt it was necessary to perform these activities before any additional controls over data maintenance could be evaluated and/or implemented. The auxiliary is in the process of implementing a reduction to the number of transactions performed in data maintenance. This action, along with the previous reduction in the number of users, significantly reduces the risks in this area.

Additionally, update access to table maintenance screens was modified, effective June 22, 2005, to restrict a user's access to only those tables where there is a business need.

Operating Agreement. The Commission's operating agreement with the auxiliary organization has not been amended, but was extended for one more year. The Single Audit recommendation will be reviewed for inclusion in the next revision of the operating agreement, which is expected to occur prior to September 30, 2006, the auxiliary's federal fiscal year end.[16]

Reference Number:	**2004-14-4**
Federal Program:	84.011
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Special Tests and Provisions. The Department of Education did not take into account all the required information when it awarded sub-grants to LEAs for Migrant Education.
Status of Corrective Action:	Partially corrected. Education developed a revised sub-grant formula process that includes the following criteria:

1. Counts of eligible migrant students.
2. Counts of eligible migrant students who moved within one year.
3. Counts of eligible migrant students ages 19 – 21.
4. Academic need.
5. Priority for services.
6. Availability of other state and federal funds.

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Each of these criteria is in place for the sub-grant funding process, with the exception of the priority for services. This factor requires extracting and matching data from two separate databases (Migrant Student Information System (MSIN) and CDE-STAR) to determine the counts of priority for service students for each grantee. Education is addressing privacy and other legal requirements before making student level state assessment data available to the MSIN.

If the priority for services data access issues are resolved, Education should implement the revised sub-grant formula process beginning with fiscal year 2006-07.[17]

Reference Number:	**2004-1-1**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Activities Allowed. The Department of Health Services (Department) applied too broadly a modification to its claims-processing system. As a result, since April 2004, the Department has been inappropriately paying Medicaid claims for services provided to certain children under its Medical Therapy Program (MTP) without attempting to bill other health coverage first.
Status of Corrective Action:	Remains uncorrected/Disagree with finding. On issues similar to this, the federal Centers for Medicare and Medicaid Services (CMS) has advised the Department that that agency would not review a waiver request from the State because of workload considerations. It would not be productive to develop and submit a waiver request to CMS on this issue as that agency would not consider it.

Also, the Medi-Cal claims processing system currently does not have access or linkage to a database or data files that would enable the system to determine if a Medi-Cal beneficiary participates in Special Education or is otherwise covered by the federal Individuals with Disabilities Education Act (IDEA). Although the Department will discuss this with the Department of Education, based on prior experience, it is anticipated that any attempt to develop such a system would be extremely challenging due to dependence on data submission from multiple entities throughout the State and the legal requirement that schools keep their data confidential. This recommendation would be inconsistent with the two main goals of: (1) ensuring a child's right to a "free and appropriate" education, and (2) maximizing federal funding, as the cost to design, implement, and later support a "Special Education" tracking system that interfaces with CA-MMIS would undoubtedly exceed the anticipated federal financial participation.

Reference Number:	**2004-1-2**
Federal Program:	93.767
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Activities Allowed. The Department of Health Services does not always ensure that the provider information and rates it uses to calculate payments for certain services provided under the State Children's Insurance Program are current.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-1-5**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2001-02

Audit Finding:	Activities Allowed. The Department of Health Services did not always ensure that services approved for Medicaid beneficiaries were medically necessary.
Status of Corrective Action:	Partially corrected. The providers identified with systemic findings in the sample of claims selected by the BSA were established as Field Audit Review cases in March 2005; however, completion of the reviews were delayed due to the 2005 Medi-Cal Payment Error Study (MPES) and two special joint projects with CMS/Medicare. The anticipated completion date for the reviews is November 2005. Audits and Investigations (A&I) is also continuing its focus on Adult Day Health Care Centers (ADHCs). In November, A&I will lead statewide onsite monitoring visits to several ADHCs. The visits will be made simultaneously and unannounced. The monitoring visits will include staff from the CDHS Licensing and Certification Division, State Controller's Office, and the Department of Aging. These ADHCs were identified as problematic during the 2005 MPES and the onsite visits will determine if the discrepancies are simply errors or indicators of possible fraud. In regards to the anticipated ADHC rate methodology change and proposed waiver, the authority to change ADHC rate methodology required legislative approval. Legislation that was introduced (AB 1258), giving CDHS the authority to amend the State Plan Amendment and change the rate methodology, was defeated.

Reference Number:	**2004-1-6**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Activities Allowed. In our fiscal year 2002-03 audit, we reported that Health Services did not recover overpayments of Medicaid funds paid to health plans as capitation payments for beneficiaries who had died and thus were no longer eligible for Medicaid.
Status of Corrective Action:	Fully corrected.[18]

Reference Number:	**2004-3-10**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Cash Management. Our review of the refund portion of worksheets that Health Services submitted to Finance for Medicaid found that Health Services did not always accurately report the dates for 5 of 12 months during fiscal year 2003-04.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-5-2**
Federal Program:	93.044
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Eligibility. The Department of Aging does not have procedures to ensure that case management providers are public or non-profit private agencies.
Status of Corrective Action:	Fully corrected.[19]

Reference Number:	**2004-5-3**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Eligibility. Our review of three of the 33 small counties not subject to Medicaid eligibility quality control reviews found that Placer County did not always ensure that it re-determined Medicaid eligibility at least once every 12 months. Specifically, although the eligibility re-determination for the Medicaid recipient we tested was due by March 2004; as of October 2004, Placer County had not yet

	performed the re-determination—7 months beyond the due date.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-12-2**
Federal Program:	93.575, 93.596
Fiscal Year Initially Reported:	2003-04
State Administering Department:	Department of Education
Audit Finding:	Reporting. The Department of Education did not report accurate data in its ACF-696 for fiscal year 2000-01, which it submitted on October 29, 2003. Because its management failed to ensure the accuracy of the report, Education overstated the State's share of expenditures by more than $6 million.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-12-5**
Federal Program:	93.767
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Reporting. The Department of Health Services does not ensure that amounts reported on its quarterly CMS-21 report are correctly classified. Although the total amounts spent on the program reported by Health Services are accurate, we were unable to verify the accuracy of detailed expenditures reported by line item or category of service.
Status of Corrective Action:	Remains uncorrected/Agree with finding. Accounting staff has met with Payment Systems Division and EDS staff on resolving the differences between the two EDS reports. Problem Statement 1819 has been developed to identify the source of the problem. To date, the source of the problem has not yet been identified and PSD/EDS continue to work on the issue.[20]

Reference Number:	**2004-13-1**
Federal Program:	93.575, 93.596
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Subrecipient Monitoring. Education does not adequately monitor its subrecipients of the child care cluster programs.
Status of Corrective Action:	Partially corrected. Necessary adjustments were made to the scheduling of reviews to ensure that all reviews were completed in a timely manner. The Error Rate Study mandated by the Legislature in fiscal year 2004-05 prevented the Education from completing all scheduled reviews during that fiscal year. The uncompleted reviews have been rescheduled for fiscal year 2005-06. At the end of fiscal year 2005-06, all reviews scheduled for both fiscal years will be completed.[21]

Reference Number:	**2004-13-6**
Federal Program:	93.044, 93.045, 93.053
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. Aging is not adequately fulfilling its responsibility to monitor the Area Agencies on Aging.
Status of Corrective Action:	Partially corrected. The Department has modified its monitoring policy for onsite assessments from Area Agencies on Aging (AAA). This policy has been approved by the U.S. Department of Health and Human Services, Administration on Aging. CDA's goal is to conduct onsite program, fiscal, and administrative assessments of AAAs at least once every four years as resources permit and onsite audits of AAAs once every three years. In addition, the Department has adopted a "risk based" approach to onsite assessments and audits and will more

frequently conduct assessments and audits for these high risk agencies.

During fiscal year 2004-05, the Department met this goal with the exception of one AAA.

Reference Number:	**2004-13-11**
Federal Program:	93.568, 93.569
State Administering Department:	Department of Community Services and Development
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The Department of Community Services and Development did not have an adequate system to ensure that it met the OMB Circular A-133 requirements it must follow when it awards federal funds to subrecipients. Further, Community Services did not ensure that 4 of 12 subrecipients with findings took appropriate and timely corrective action. Finally, Community Services could not provide sufficient evidence to support its decision to waive the repayment of approximately $350,000 in federal funds for one subrecipient's disallowed costs.
Status of Corrective Action:	Fully corrected.[22]

Reference Number:	**2004-13-13**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Subrecipient Monitoring. The Department of Health Services does not have a formal process to ensure that Medicaid subrecipients take appropriate corrective action to findings identified in OMB Circular A-133 audit reports.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-13-14**
Federal Program:	93.917
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. We identified Health Services' site visit goals as a key component of its subrecipient monitoring process for the HIV Care Formula Grants program. However, Health Services is not performing site visits as frequently as its goals state.
Status of Corrective Action:	Case Management Program (CMP). Fully corrected. Care Services Program (CSP). Partially corrected. Due to staff attrition and the need to train new staff, CSP was not able to visit all 11 subrecipients by December 31, 2005. Two monitoring visits have been completed (as of November 2), with an additional four scheduled for November and December 2005. The remaining five subrecipients will be monitored with priority given to those subrecipients who: (1) have not had a recent DHS audit, (2) have not had a recent HRSA site visit (i.e., the Eligible Metropolitan Areas [EMAs]), and (3) have experienced problems in invoicing, data reporting, or programmatic duties. AIDS Drug Assistance Program (ADAP). Partially corrected. In light of escalating administrative responsibilities, ADAP did not establish a subrecipient monitoring goal for itself for fiscal year 2005-06. The program continues to prioritize its visits to those doing the most ADAP enrollment/eligibility recertification, and those who have not been visited in the past five years. ADAP is still considering using its eligibility data as indicators of possible eligibility screening irregularities, but to date staff has not evaluated which data elements may prove most indicative of potential problems. ADAP has indicated a need for increased staffing, largely to increase its level of subrecipient monitoring.

	Combined responses for CMP, CSP, and ADAP. The Branch looked at the possibility of consolidating site visits between programs, but to date has not determined that it is feasible to do so. Surprisingly, there are not as many "common" grantees between care and treatment programs as was expected.[23]

Reference Number:	**2004-14-1**
Federal Program:	93.563
State Administering Department:	Department of Child Support Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Special Tests and Provisions. In our review of 20 requests from other states for case status reviews, we found that for 13 requests, DCSS did not indicate the dates it received the requests; therefore, we were unable to determine whether DCSS responded within 5 days. For the remaining 7 requests, DCSS took more than the required 5 days to respond to 2 requests, taking 8 days for one request and 22 days for the second.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-14-2**
Federal Program:	93.959
State Administering Department:	Department of Alcohol and Drug Programs
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Special Tests and Provisions. The Department of Alcohol and Drug Programs did not ensure that independent peer reviews were conducted for at least 5 percent of the treatment providers receiving funds from the Block Grants for Prevention and Treatment for Substance Abuse program.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-14-5**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	1997-98
Audit Finding:	Special Tests and Provisions. Our review of selected Medicaid providers revealed that the Department of Health Services did not always have the required agreements, disclosures, licenses, and certifications on file.
Status of Corrective Action:	Partially corrected. As part of the Department's re-enrollment plan, all Medi-Cal providers will be re-enrolled, as a continuous process, to verify and update their original enrollment information and to ensure compliance with current state and federal regulations. The Provider Enrollment Branch (PEB) has implemented procedures to more efficiently review and process re-enrollment applications based upon data driven targeting of established fraud indicators (consistent with the Malcolm Sparrow anti-fraud model). As part of this process, high-risk provider types will be identified, by PEB and Audits and Investigations (A&I), using an on-going risk assessment analysis and the annual Medi-Cal Payment Error Study (MPES), allowing PEB to prioritize the review of these providers re-enrollment. This will provide for the verification and update of the original provider enrollment information, ensuring compliance with current state and federal regulations. PEB will annually review current practices to identify and prioritize policies and procedures that can be updated and streamlined, facilitating the re-enrollment process.[24]

Reference Number:	**2004-9-5**
Federal Program:	97.036 (formerly 83.544)
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	2003-04

Audit Finding:	Suspension and Debarment. Emergency Services did not require applicants to the Public Assistance Grants program to submit suspension and debarment certifications. By not requiring these certifications, Emergency Services risks allowing suspended or debarred parties to participate in the federal program.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2004-12-3**
Federal Program:	97.036 (formerly 83.544)
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Reporting. Emergency Services reported incorrect financial information in its June 2004 quarterly progress report.
Status of Corrective Action:	Fully corrected.[25]

Reference Number:	**2004-12-4**
Federal Program:	97.036 (formerly 83.544), 97.039 (formerly 83.548)
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	1999-2000
Audit Finding:	Reporting. Emergency Services' financial status reports do not always contain complete expenditure information.
Status of Corrective Action:	Remains uncorrected/Agree with finding. OES has continued to experience staffing shortages. Also, the current accounting system we are mandated to use for all fiscal transactions has limited functionality. Due to the age of many disaster grants (6 to 16 years), many records may not be available, or are incomplete. Further, there are hundreds of recipients and thousands of projects associated with these grants. Many state and federal fiscal years have passed and even after a labor intensive and cumbersome process, we would not be able to update current accounting records. Therefore, we

continue to negotiate with FEMA on an on-going basis regarding the appropriate reporting of grant expenditures, administrative allowances, and other pertinent information.[26]

Reference Number:	**2004-13-8**
Federal Program:	97.036 (formerly 83.544)
State Administering Department:	Office of Emergency Services
Fiscal Year Initially Reported:	2003-04
Audit Finding:	Subrecipient Monitoring. Emergency Services did not adequately monitor subrecipients of federal funds from the Public Assistance Grants program.
Status of Corrective Action:	Partially corrected. Specifically, the finding was that "…OES did not provide status information for all of the open large projects listed on the report." In response to last year's findings, OES Public Assistance (PA) provided an e-mail from Don Smith, FEMA PA Officer for DR 1008, Pasadena Long-Term Recovery Office. In his e-mail, Don explained why large project monitoring is not necessary for OES to perform for DR 1008 because FEMA is lead for DR 1008 and is doing the monitoring. Specifically, he stated that, "The Northridge Long-Term Recovery Office has developed and continues to use an internal database for maintaining the current status of all open projects. The database is continually updated with information gained through on-going interaction between FEMA, the Sub-grantees, and OES. Although the database is our (FEMA's) primary tool for maintaining project status, the Quarterly Report provided by OES serves a valuable purpose in that it allows us to verify our mutual understanding of the project status." In addition, OES has a signed agreement with FEMA regarding large project monitoring wherein FEMA agreed that due to the magnitude of DR 1008 and subsequent disasters prior to DR 1498, that OES PA will not be monitoring all large projects. Instead, large projects for these disasters are included in the OES Large Project Monitoring Program (LPMP) based upon a risk-based approach agreed upon by the FEMA Disaster Recovery Manager (DRM). As a result, OES only monitors those large projects that meet the LPMP criteria and these are the only

projects included in the LPMP spreadsheet that is included in the Quarterly Report (QR) to FEMA for disasters prior to DR 1498.

For DR 1498 and all subsequent disasters, all large projects are monitored by OES and the information is collected on a continuous basis by the OES PA staff assigned to these sub-grantees. Their supervisor is responsible for updating the project data of the QR containing the sub-grantees assigned to their staff. This information is compiled quarterly and included in the QR to FEMA.

Unfortunately, since the closure of the OES office in Pasadena in October of 2003, OES no longer has permanent PA staff in southern California. Therefore, the majority of OES PA HQ staff in Sacramento have been deployed to southern California since October 2003 to draft PWs, resolve eligibility issues with FEMA, and provide technical assistance to sub-grantees for DR 1498 (Southern California Firestorms), DR 1505 (San Simeon Earthquake), DR 1577 (Southern California Winter Storms) and DR 1585 (February Winter Storms). The two most recent disasters listed here constitute a significant new workload for OES PA with 498 new applicants, 3,978 initial PWs, 88 appeals (to date), other related correspondence, and Final Inspection Reports. Therefore, any missing project monitoring data this fiscal year is due to lack of PA staffing resources.

This is also the reason for the delay in implementing the Automated Quarterly Reporting System whereby sub-grantees for DR 1498 and all subsequent disasters will submit their own project status reports reducing the burden on OES staff. In September 2005, the OES Deputy Director of Response and Recovery approved the system developed by PA staff to automate the sub-grantee quarterly progress reporting process and authorized the PA program to deny funding for sub-grantees that do not submit their quarterly large project progress reports to OES in a timely manner. A pilot of this new process is to be implemented for DR 1505 in December 2005. Until this process is fully implemented, it is the responsibility of the PA supervisor to insure that this information is compiled and included in the QR to FEMA.

For disasters prior to DR 1498, the PA section is making every effort to collect the information needed from sub-grantees to complete the Quarterly Cost Projection Reports (QCPR) for all projects included in the LPMP. However, due to lack of staff, some PA supervisors are collecting the required information via e-mails and phone calls instead of completing a QCPR for each project. This information is then used to update the QR to FEMA. Please note that all PA QRs this fiscal year have been submitted to FEMA on time.

In addition, per the FEMA approved OES State Administrative Plan for Public Assistance (Plan), during the application closeout phase, all projects are subject to a final inspection including field reviews. OES employs a risk-based approach in the preparation of Final Inspection Reports, per an agreement between OES and FEMA Region IX, and conducts "Interim Final Inspections" upon request to expedite the closeout process. At the time of application closeout, OES makes a claim to the FEMA Regional Director for final reimbursement of eligible costs for each large project. In submitting such claims, OES will clarify: (1) reported costs have been incurred in the performance of eligible work, (2) all approved work has been completed, (3) all projects are in compliance with the FEMA-State Agreement, and (4) all payments for that project have been made.

The Plan has been modified to reflect these changes in the PA project monitoring and quarterly reporting process (the draft is complete and under PA management review).

ENDNOTES—AUDITOR COMMENTS

[1] The status of this issue remains unchanged. Please refer to reference number 2005-12-1 for additional information.

[2] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-13-1 for additional information.

[3] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-12-3 for additional information.

[4] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-13-2 for additional information.

[5] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-2-2 for additional information.

[6] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-9-2 for additional information.

[7] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-2-3 for additional information.

[8] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-3-1 for additional information.

[9] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-3-3 for additional information.

[10] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-3-4 for additional information.

[11] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-3-2 for additional information.

[12] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-3-5 for additional information.

[13] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-5-1 for additional information.

[14] We reported a similar weakness in our audit of fiscal year 2004-05 for federal program 84.298 only. Please refer to reference number 2005-7-2 for additional information. For clarification purposes, we are presenting the official program names. Title I is Title I Grants to Local Education Agencies; Title II is Improving Teacher Quality State Grants; Title III is English Language Acquisition Grants; Title V is State Grants for Innovative Programs; and Vocational Education is Vocational Education - Basic Grants to States.

[15] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-7-1 for additional information.

[16] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-14-3 for additional information.

[17] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-14-1 for additional information.

[18] Although Health Services has requested approval from the federal Centers for Medicare and Medicaid Services to forgive past overpayments, it has not yet received approval.

[19] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-5-2 for additional information.

[20] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-12-4 for additional information.

[21] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-13-3 for additional information.

[22] For our audit of fiscal year 2003-04, we reported that Community Services could not provide sufficient evidence to support its decision to waive the repayment of approximately $350,000 in federal funds for one subrecipient's disallowed costs. At that time, Community Services said that it planned to collect the disallowed costs. However, in an effort to avoid litigation expenses and in recognition of the uncertain outcome if the matter were put to a neutral fact finder, Community Services and the subrecipient entered a settlement agreement (agreement) instead. According to the agreement, both parties consent to reduce the amount in controversy to $169,121.50. In addition, the agreement states that Community Services is not characterizing this amount as disallowed costs, a debt to be repaid or any other kind of liability, and that the subrecipient satisfies its obligation under the agreement by disavowing eligibility to receive this amount from the leveraged incentive fund and another fund that Community Services administers.

[23] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-13-4 for additional information.

[24] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-14-4 for additional information.

[25] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-12-2 for additional information.

[26] We reported a similar weakness in our audit of fiscal year 2004-05. Please refer to reference number 2005-12-6 for additional information.

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

ARNOLD SCHWARZENEGGER, GOVERNOR
STATE CAPITOL ■ ROOM 1145 ■ SACRAMENTO CA ■ 95814-4998 ■ WWW.DOF.CA.GOV

April 18, 2006

Ms. Elaine M. Howle, State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2005

Thank you for the opportunity to respond to the internal control and state and federal compliance audit report. This report was the result of your examination of the state's general purpose financial statements and administration of federal programs for the fiscal year ended June 30, 2005, and will be part of the Single Audit Report covering this period. We accept the reported findings and recommendations. Although our internal controls and administration of federal awards can always be improved, the state is committed to sound and effective fiscal oversight.

California provides its citizens with numerous state and federal programs and activities and is much more complex and vast than most economic entities in the world. Such complexity, along with ever-present budget constraints, challenges us to meet the requirements of those programs and activities efficiently and effectively. Moreover, such operations must exist within a system of internal and administrative control that safeguards assets and resources and produces reliable financial information. Attaining these objectives and overseeing the financial and business practices of the state continues to be an important part of the Department of Finance's leadership.

In meeting our responsibility for financial leadership and oversight, the Department of Finance conducts internal control reviews of state departments and also reviews areas of potential weakness in the state's fiscal systems. In addition, we provide oversight of departmental internal audit units by issuing audit guidelines and conducting quality assurance reviews. Further, we have an ongoing process of issuing audit memos to departments that establish statewide policy and provide technical advice on various audit related issues. We will soon issue an audit memo concerning the results of the fiscal year 2004-05 Single Audit.

The head of each state department is responsible for establishing and maintaining a system of internal accounting and administrative control within their department. This responsibility includes documenting the system, communicating system requirements to employees, and assuring that the system is functioning as prescribed and is modified for changing conditions.

Moreover, all levels of state management must be involved in assessing and strengthening their system of internal accounting and administrative controls to minimize fraud, errors, abuse, and waste of government funds.

Individual departments have separately responded to the report's findings and recommendations. Accordingly, their viewpoints and corrective action plans are included in the report. We will monitor the findings and reported corrective actions to identify potential changes in statewide fiscal procedures.

The Department of Finance will continue to provide leadership to ensure the proper financial operations and business practices of the state, and to ensure that internal controls exist for the safeguarding and effective use of assets and resources.

If you have any questions concerning this letter, please contact Diana L. Ducay, Chief, Office of State Audits and Evaluations, at (916) 322-2985.

Sincerely,

(Original Signed By:)

MICHAEL C. GENEST
Director