Single Audit Report 2005-06

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 25, 2007

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, 2006. 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. In addition, 18 instances of noncompliance were considered material. Accordingly, we recognize that our internal controls and administration of federal awards need to be improved. As a result, the state has taken a proactive approach by implementing changes to the Financial Integrity and State Manager's Accountability Act (FISMA) reporting requirements. Beginning in the current year, each agency now must conduct an internal review of their controls and prepare a report of the findings. A certification letter alone will not meet the FISMA requirements. The state will continue to emphasize its commitment to sound and effective fiscal oversight.

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 controls 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. In meeting our responsibility for financial leadership and oversight, the Department of Finance will continue to conduct internal control reviews of state departments, review areas of potential weakness in the state's fiscal systems, issue audit guidelines, conduct quality assurance reviews, and issue audit memos to departments that establish statewide policy and provide technical advice on various audit related areas. We will soon issue an audit memo concerning the results of the fiscal year 2005-06 Single Audit and remind all departments of the new internal auditing standards and processes included in Chapter 452, Statutes of 2006 (SB 1452). The Department of Finance is committed to providing 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,

/s/ Michael C. Genest

MICHAEL C. GENEST
Director

Enclosure

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Overview of California's Economy

Fiscal Year 2005-06

The California and national economies got off to fast starts in 2006, but declining housing sectors increasingly weighed on the economies as the year progressed. While on the whole, 2006 was a better year than 2005 for the state and national economies, neither economy entered 2007 with much momentum.

The Nation - Slowing Growth

The downturn in the nation's housing sector is by far the dominant factor in the slowdown in 2006. Declines in residential construction reduced real GDP growth by 0.7 percentage points in the second quarter of 2006, and 1.2 percentage points in both the third and fourth quarters, pulling real GDP growth below 3 percent in all three quarters. Cuts in residential construction are expected to continue to place a drag on real GDP growth in the first quarter of 2007, but then loosen up thereafter.

The slowdown in the nation's housing sector is now evident in almost every measure of the sector. The value of new residential construction fell 13 percent in 2006. Sales of existing single-family homes fell nearly 8 percent, while the median sales price was essentially stagnant.

Light vehicle sales dropped sharply in October and November of 2006, and automakers responded by making production cuts, some of them extending through the first half of 2007.

Other sectors of the economy may experience some slowdown in growth, but most are expected to hold up quite well in 2007, the most important being consumer spending. Consumer spending is expected to continue growing at a rate somewhat higher than that of economic output. There is little evidence that consumers have cut back their spending because reduced home price gains or price declines have made them feel less well off.

While the outlook is for slower, but still positive growth, the major risk for even slower growth would be if there is a longer and deeper decline in housing and higher mortgage rates.

California - Slowing Growth As Well

As in the nation as a whole, a downturn in the state's housing sector is primarily behind the slowing of the California economy in the second half of 2006. A second, but considerably smaller, factor is reduced light vehicle sales.

The state's housing sector has turned down more sharply than has the national housing sector. The number of new home building permits issued in 2006 was 22 percent below 2005. Sales of existing single-family detached homes were down almost 24 percent. Price gains have moderated considerably, and some counties, including six of the nine Bay Area counties, have experienced year-over-year price declines. The number of foreclosures in the third quarter of 2006 was more than double the year-earlier level. Residential permits are projected to fall again in 2007 before rebounding in 2008.

California participated in the decline in auto sales in October and November. In fact, sales in the state were described as especially weak in news reports.

A number of measures of the California economy, while showing signs of slowing, are quite strong—personal income, taxable sales, private-sector nonresidential and public works construction, and state exports.

Personal income—income received by California residents from all sources—was up 6.4 percent in 2006 from a year earlier, and wages and salaries 7.1 percent. Both grew considerably quicker than in 2005. Personal income posted a 5.4 percent gain in 2005 as a whole, for example. Personal income is expected to benefit in 2007 from large bonuses on work done in 2006, as well as increased equity-related compensation.

Private-sector nonresidential construction was strong again in 2006 with large gains in office, hotel and motel, and parking garage construction and alterations and additions. Work on the new Bay Bridge helped public works construction surge by over 20 percent in 2006. Private sector nonresidential construction is expected to post high single-digit percentage gains and public works construction, mid-to-high single-digit percentage gains in 2007 and 2008.

Made-in-California merchandise exports set a record in 2006 and were up over 9 percent from 2005. Gains in exports to mainland China and Mexico dwarfed those to other destinations. High-tech exports grew, but not as quickly as total exports.

Industry employment growth in 2006 was slightly better than in 2005. Smaller job gains in retail trade, construction, and financial activities were offset by bigger job gains in professional and business services, leisure and hospitality, government, and education and health services.

The state's unemployment rate dropped from an average of 5.4 percent in 2005 to 4.9 percent in 2006, as the number of unemployed persons fell below 900,000 for the first time in five years.

While the outlook is for slower, but still positive growth, the major risk for even slower growth would be if there is a longer and deeper decline in housing and higher mortgage rates. California's economy, like those of other states with expensive housing, is particularly sensitive to changes in interest rates. A jump in mortgage rates would raise payments for home owners with adjustable rate mortgages and come at the same time as the first wave of refinancing of the various five-year balloon mortgages.

As the fifth year of economic expansion comes to a close, the national and California economies are facing increased risks. Slower growth, stable energy prices, moderating inflation, and stable to lower interest rates might be the best possible outcome in the near-term.

Part One

State of California Financial Report for the Year Ended June 30, 2006

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CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

DOUG CORDINER
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 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, 2006, 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 82 percent, 42 percent, and 52 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 89 percent, 79 percent, and 86 percent, respectively, of the assets, net assets, and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 69 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, 2006, 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 and schedules 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 statements and schedules 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 21, 2007

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, 2006. We encourage readers to consider the information we present here in conjunction with the information presented in the Controller's 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 better-than-expected growth in the 2005-06 fiscal year, resulting in a significant increase in general revenues, primarily personal income tax revenues. Even though the State increased program expenses and reduced budgetary borrowing, revenues for the year exceeded expenses, transfers, and special item for governmental activities. Total revenues for the State's business-type activities also exceeded expenses for the year. Therefore, net assets for the 2005-06 fiscal year for both governmental and business-type activities increased by 9.7% over last year.

Net Assets — The primary government's net assets as of June 30, 2006, were $48.6 billion. After the total net assets are reduced by $84.3 billion for investment in capital assets (net of related debt) and by $17.2 billion for restricted net assets, the resulting unrestricted net assets were a negative $52.9 billion. Restricted net assets are dedicated for specified uses and are not available to fund current activities. More than half of the negative $52.9 billion consists of $32.2 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 $4.3 billion (9.7%) during the year ended June 30, 2006. Net assets of governmental activities increased by $2.7 billion (7.7%), while net assets of business-type activities increased by $1.6 billion (16.9%).

Fund Highlights

Governmental Funds — As of June 30, 2006, the primary government's governmental funds reported a combined ending fund balance of $17.2 billion, an increase of $2.8 billion from the previous fiscal year. After the total fund balance is reduced by $18.2 billion in reserves, the unreserved fund balance totaled a negative $1.0 billion.

Proprietary Funds — As of June 30, 2006, the primary government's proprietary funds reported combined ending net assets of $12.0 billion, an increase of $1.7 billion from the previous fiscal year. After the total net assets are reduced by $1.2 billion for investment in capital assets (net of related debt) and expendable restrictions of $8.7 billion, the unrestricted net assets totaled $2.1 billion.

Noncurrent Assets and Liabilities

As of June 30, 2006, the primary government's noncurrent assets totaled $121.3 billion, of which $95.6 billion is related to capital assets. State highway infrastructure assets of $55.7 billion represent the largest part of the State's capital assets.

The primary government's noncurrent liabilities totaled $95.5 billion, which consists of $47.0 billion in general obligation bonds, $29.1 billion in revenue bonds, and $19.4 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's financial statements include the information for 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 and the State Teachers' 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 9.7%, from $44.3 billion, as restated at June 30, 2005, to $48.6 billion a year later. This was slightly lower than the 10.3% increase reported in the 2004-05 fiscal year.

The primary government's $84.3 billion investment in capital assets, such as land, building, equipment, and infrastructure (roads, bridges, and other immovable assets), comprise a significant portion of its net 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 $17.2 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, 2006, governmental activities showed an unrestricted net assets deficit of $54.7 billion and business-type activities showed unrestricted net assets of $1.8 billion.

A large portion of the negative unrestricted net assets of governmental activities is composed of $32.2 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 and 2006
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2006	2005*	2006	2005*	2006	2005*
ASSETS						
Current and other assets	$ 50,240	$ 43,094	$ 34,683	$ 32,661	$ 84,923	$ 75,755
Capital assets	89,763	87,178	5,849	6,410	95,612	93,588
Total assets	**140,003**	**130,272**	**40,532**	**39,071**	**180,535**	**169,343**
LIABILITIES						
Noncurrent liabilities	69,382	65,953	26,093	26,383	95,475	92,336
Other liabilities	33,411	29,739	3,097	3,050	36,508	32,789
Total liabilities	**102,793**	**95,692**	**29,190**	**29,433**	**131,983**	**125,125**
NET ASSETS						
Investment in capital assets net of related debt	83,489	79,580	818	837	84,307	80,417
Restricted	8,431	7,631	8,723	7,235	17,154	14,866
Unrestricted	(54,710)	(52,631)	1,801	1,566	(52,909)	(51,065)
Total net assets	**$ 37,210**	**$ 34,580**	**$ 11,342**	**$ 9,638**	**$ 48,552**	**$ 44,218**

* Not restated

Changes in Net Assets

The expenses of the primary government totaled $182.5 billion for the year ended June 30, 2006. Of this amount, $84.3 billion (46.2%) was funded with program revenues (charges for services or program-specific grants and contributions), leaving $98.2 billion to be funded with general revenues (mainly taxes). The primary government's general revenues and special item of $102.5 billion exceeded the net unfunded expenses. As a result, during the year total net assets increased by $4.3 billion, or 9.7%.

Of the total increase, net assets for governmental activities increased by $2.7 billion, while those for business-type activities increased by $1.6 billion. The increase in governmental activities is primarily due to increased personal income tax revenue. 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 and 2006
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2006	2005	2006	2005	2006	2005
REVENUES						
Program revenues:						
Charges for services	$ 19,188	$ 16,040	$ 21,540	$ 21,417	$ 40,728	$ 37,457
Operating grants and contributions	42,254	41,135	—	—	42,254	41,135
Capital grants and contributions	1,273	1,090	57	73	1,330	1,163
General revenues:						
Taxes	100,461	90,908	—	—	100,461	90,908
Investment and interest	505	289	—	—	505	289
Miscellaneous	292	526	—	—	292	526
Total revenues	**163,973**	**149,988**	**21,597**	**21,490**	**185,570**	**171,478**
EXPENSES						
Program expenses:						
General government	9,675	8,809	—	—	9,675	8,809
Education	62,653	53,153	—	—	62,653	53,153
Health and human services	65,763	62,017	—	—	65,763	62,017
Resources	4,162	4,161	—	—	4,162	4,161
State and consumer services	596	1,038	—	—	596	1,038
Business and transportation	8,809	7,142	—	—	8,809	7,142
Correctional programs	7,299	6,611	—	—	7,299	6,611
Tax relief	704	2,157	—	—	704	2,157
Interest on long-term debt	2,894	2,408	—	—	2,894	2,408
Electric Power	—	—	5,342	5,655	5,342	5,655
Water Resources	—	—	950	731	950	731
Public Building Construction	—	—	334	300	334	300
State Lottery	—	—	3,912	3,494	3,912	3,494
Unemployment Programs	—	—	8,585	8,940	8,585	8,940
Nonmajor enterprise	—	—	814	746	814	746
Total expenses	**162,555**	**147,496**	**19,937**	**19,866**	**182,492**	**167,362**
Excess (deficiency) before transfers	**1,418**	**2,492**	**1,660**	**1,624**	**3,078**	**4,116**
Transfers	23	28	(23)	(28)	—	—
Special item	1,218	—	—	—	1,218	—
Change in net assets	2,659	2,520	1,637	1,596	4,296	4,116
Net assets, beginning of year (restated)	**34,551**	**32,060**	**9,705**	**8,042**	* **44,256**	**40,102**
Net assets, end of year	**$ 37,210**	**$ 34,580**	**$ 11,342**	**$ 9,638**	**$ 48,552**	**$ 44,218**

* Not restated

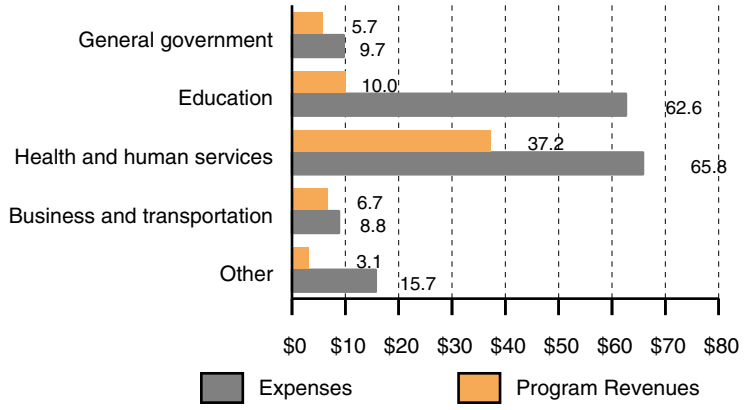
Governmental Activities

Governmental activities expenses totaled $162.6 billion. Program revenues funded only $62.7 billion (38.6%) of that amount, including $43.5 billion received in federal grants, and general revenues (mainly taxes) funded the remaining $99.9 billion. General revenues, transfers, and special item for governmental activities totaled $102.5 billion. Thus, governmental activities' total net assets increased by $2.7 billion, or 7.7%, during the year ended June 30, 2006.

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, 2006
(amounts in billions)



For the year ended June 30, 2006, total state tax revenues collected for governmental activities increased by 10.5% over the prior year. The largest increase in state tax revenue occurred in personal income taxes, due to higher-than-expected levels of capital gains from large stock-related transactions and real estate sales, as well as strong business earnings.

Overall expenses for governmental activities increased from the prior year—a $15.1 billion (or 10.2%) increase. The expenses for all activities except state and consumer services and tax relief increased. The largest increases in expenses were a $9.5 billion increase in education spending and a $3.7 billion increase in health and human services spending. Education spending increased for enrollment growth, cost-of-living adjustments, funding restorations to ongoing programs, and the partial settle-up for prior-year Proposition 98 obligations. The increase in health and human services spending was the result of ongoing growth in caseloads and increases in costs and utilization of medical services. The $1.5 billion decrease in tax relief expenses was the result of the full repayment, in the prior year, of the vehicle license fee gap loan from local governments.

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, 2006
(as a percent)

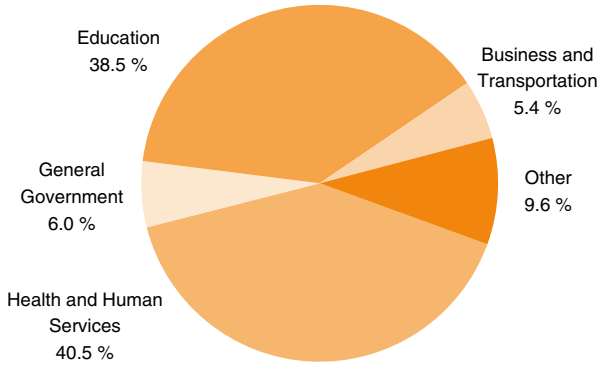
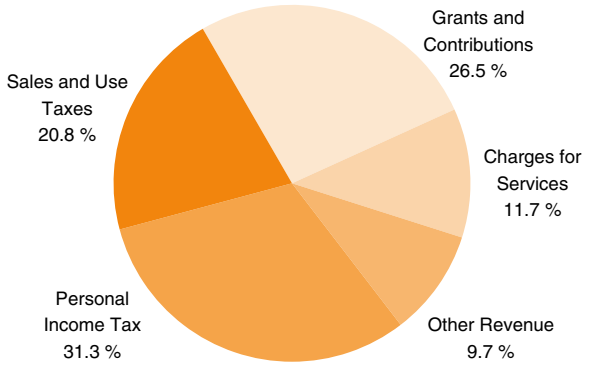


Chart 3

Revenues by Source
Year ended June 30, 2006
(as a percent)



Business-type Activities

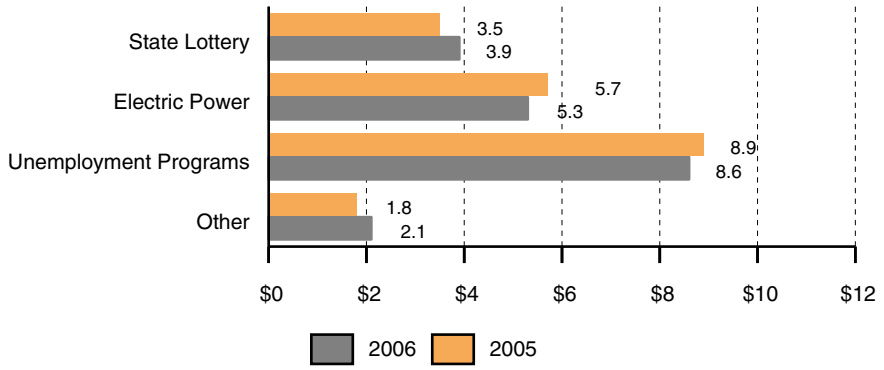
Business-type activities expenses totaled $19.9 billion. Program revenues of $21.6 billion were generated primarily from charges for services that fully paid these expenses. Consequently, business-type activities' total net assets increased by $1.6 billion, or 16.9%, during the year ended June 30, 2006.

Most of the increase in net assets was due to a $1.7 billion increase in unemployment programs' net assets, discussed in more detail in the Fund Financial Analysis section under Proprietary Funds. The revenues of the unemployment programs exceeded expenditures and transfers, due to 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 2005-06 fiscal year. Governmental funds rely heavily on taxes to support the majority of the State's services and programs. Personal income and sales and use taxes increased during the year. 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, 2006.

Governmental Funds

The governmental funds' Balance Sheet reported $54.4 billion in assets, $37.2 billion in liabilities, and $17.2 billion in fund balance as of June 30, 2006. The largest change in account balance was a $4.5 billion increase in cash and pooled investments that relates to the higher-than-expected increase in state tax revenue. Within the total fund balance, $18.2 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 ($5.3 billion), noncurrent interfund receivables and loans receivable ($4.5 billion), continuing appropriations ($7.8 billion), and debt service ($606 million). The unreserved balance of the governmental funds is a negative $1.0 billion.

The Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds shows $163.9 billion in revenues, $170.1 billion in expenditures, and a net $9.0 billion in receipts from other financing sources (uses). The ending fund balance of the governmental funds for the year ended June 30, 2006, was $17.2 billion, a $2.8 billion increase over the previous year's restated ending fund balance of $14.4 billion. The increase in the combined fund balance of the governmental funds was a result of an increase in personal income and sales and use taxes, in both the General Fund and the nonmajor governmental funds. Personal income taxes, which account for 50.6% of tax revenues and 31.0% of total governmental fund revenues, increased by $8.2 billion over the previous fiscal year. The increase in state tax revenues is attributable to the growth in the economy, higher-than-expected levels of capital gains from large stock-related transactions and real estate sales, strong business earnings, and increased 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 $2.7 billion. The Federal Fund and the Transportation Construction Fund ended the fiscal year with fund balances of $34 million and $3.4 billion, respectively. The nonmajor governmental funds ended the year with a total fund balance of $11.1 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 $21.8 billion, liabilities of $19.1 billion, and fund balance reserves of $2.0 billion, leaving the General Fund with an unreserved fund balance of $673 million. The largest change in asset accounts was in cash and pooled investments, which increased from $8.1 billion to $11.7 billion. The increase is primarily due to higher-than-expected cash receipts associated with personal income taxes.

The largest change in liability account balances was an increase of 63.3% in due to other governments (from $2.8 billion to $4.6 billion). The increase in the amount due to other governments was caused mainly by the $1.2 billion current liability for state mandated cost reimbursements to schools and other local governments. Beginning with the 2002-03 fiscal year, the State deferred funding for mandated cost reimbursement programs, but with the increase in General Fund revenues, the State provided funding in the 2006-07 fiscal year budget to pay approximately 42% of the deferred claims for local agencies, school districts, and community colleges.

As shown on the Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds, the General Fund had $93.4 billion in revenues, $89.2 billion in expenditures, and a net $1.7 billion disbursement from other financing sources (uses) for the year ended June 30, 2006. The largest source of General Fund revenue was $90.9 billion in taxes, comprised primarily of personal income taxes ($49.9 billion) and sales and use taxes ($27.6 billion).

The taxes with the largest increase in revenues were personal income taxes, which increased by $7.5 billion (17.6%). This increase can be attributed to the higher-than-expected revenues from the growth in the economy, higher-than-expected levels of capital gains from large stock-related transactions and real estate sales, and strong business earnings. Sales and use taxes increased by $1.8 billion (7.1%), to $27.6 billion; this increase can be attributed to strong consumer spending demonstrated by increased taxable sales.

General Fund expenditures increased by $8.8 billion, to $89.2 billion. The programs with the largest increases were education, which increased by $5.8 billion, to $46.6 billion; health and human services, which increased by $1.3 billion, to $26.2 billion; and correctional programs, which increased by $906 million, to $7.5 billion.

The increase in education expenditures consists of increased funding for enrollment growth and cost-of-living adjustments, partial restoration of deficit funding reductions, and partial payment for prior-year state mandate and Proposition 98 obligations. Health and human service expenditures increased primarily due to ongoing growth in medical and social services caseloads, increases in costs and utilization of medical services, and rate increases for nursing homes and certain other providers. Correctional program expenditures increased primarily to support the reorganization of the correctional program, activate a new prison, fill vacant positions, expand the officer academy, and improve medical and dental services. The General Fund's ending fund balance (including reserves) for the year ended June 30, 2006, was $2.7 billion, an increase of $2.5 billion over the previous year's ending fund balance of $187 million.

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 $31.3 billion (73.6%) of the total $42.5 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—$7.0 billion (16.5%)—most of which were apportionments made to local educational agencies (school districts, county offices of education, community colleges, etc.).

The Federal Fund's revenues and expenditures increased by approximately the same amount, with revenues increasing slightly more than expenditures, resulting in a $7 million increase in fund balance from the prior year.

Transportation Construction Fund: This fund accounts for gasoline taxes, bond proceeds, and other revenues used for highway and passenger rail construction. Expenditures increased by 25.5%, while revenues remained relatively stable, with only a 2.5% increase from the prior year. Fund expenditures of $4.5 billion exceeded revenues by $819 million. However, the fund balance decreased by only $333 million, due to an increase in transfers from the General Fund.

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 $1.7 billion.

As shown on the Statement of Net Assets of the proprietary funds, total assets of the enterprise funds were $41.0 billion as of June 30, 2006. Of this amount, current assets totaled $12.9 billion and noncurrent assets totaled $28.1 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. Unemployment Programs Fund revenues exceeded expenditures and transfers, leading to the total increase of $1.9 billion in the two asset account balances. The total liabilities of the enterprise funds were $29.7 billion. The largest liability accounts were revenue bonds payable of $21.9 billion and general obligation bonds payable of $1.8 billion. These accounts decreased during the year because redemption paid on outstanding bonds and bond defeasances exceeded new bonds issued.

Total net assets of the enterprise funds were $11.3 billion as of June 30, 2006. Total net assets consisted of three segments: expendable restricted net assets of $8.7 billion; investment in capital assets (net of related debt) of $818 million; and unrestricted net assets of $1.8 billion. The Unemployment Programs Fund had the largest net assets, with $5.7 billion (50.4% of the enterprise funds' total net assets). The expendable restricted net assets of the Unemployment Programs Fund increased by $1.7 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 $20.1 billion, operating expenses of $17.2 billion, and net disbursements from other transactions of $1.3 billion. The largest sources of operating revenue were unemployment and disability insurance receipts of $9.9 billion in the Unemployment Programs Fund and power sales of $4.4 billion collected by the Electric Power Fund. The largest operating expenses were distributions to beneficiaries of $8.4 billion by the Unemployment Programs Fund and power purchases (net of recoverable costs) of $4.3 billion by the Electric Power Fund. The ending net assets of the enterprise funds for the year ended June 30, 2006, were $11.3 billion, or $1.6 billion more than the previous year's restated ending fund balance of $9.7 billion. The main reason for the increase was the $1.7 billion gain from the Unemployment Programs Fund caused by increased tax rate schedules and a decrease in distributions to beneficiaries caused by less unemployment in the state.

Internal Service Funds: Total net assets of the internal service funds were $666 million as of June 30, 2006. These net assets consist of two segments: investment in capital assets (net of related debt) of $399 million and unrestricted net assets of $267 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 $2.1 billion. The pension and other employee benefit trust funds ended the fiscal year with net assets of $363 billion. The State's only investment trust fund, the Local Agency Investment Fund, ended the fiscal year with net assets of $16.4 billion. Agency funds act as clearing accounts and thus do not have net assets.

For the year ended June 30, 2006, the fiduciary funds' combined net assets were $381 billion, a $35.2 billion increase from prior year restated net assets. The main reason for the increase in net assets was from investment income and an increase in the fair value of investments of retirement funds.

The Economy for the Year Ending June 30, 2006

The big economic news in California and nationally was the impact of increases in interest rates and oil prices. The Federal Open Market Committee raised short-term interest rates by one-quarter of one percent at each of its eight meetings between July 2005 and June 2006, for a total of two percentage points. The federal funds rate increased from 3.25% to 5.25% and the discount rate increased from 4.25% to 6.25%. The federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve Bank to other depositories overnight. Oil prices increased over 30% during the 2005-06 fiscal year. The impact of both the interest rate increase and the oil price increase resulted in a slowing of the economy, but the slowdown was not as severe as some had predicted. Although short-term interest rates rose by two percentage points during the 2005-06 fiscal year, mortgage rates rose more slowly—by only one percentage point.

The real estate market took the brunt of the economic slowdown. In June 2005, residential real estate sales had reached an all-time high in California, but by June 2006, sales were down 21%. Home prices continued to increase during the 2005-06 fiscal year, but by only 7.4% over the prior year, the smallest annual increase since October 2001. Residential construction permits reached a fiscal year peak of 275,000 units (seasonally adjusted annual rate) in September 2005, but declined 25% by June 2006.

Employment in California was also affected by the real estate slowdown. From June 2005 through December 2005, construction jobs increased by 34,000, but these jobs increased by only 8,100 during the first six months of 2006.

Although decreased construction and manufacturing activity associated with residential real estate slowed the economy, it did not halt growth in service jobs. From January through June 2006, service sector jobs grew at an annualized rate of 1.7%. Personal income growth for the fiscal year was strong, a 6.6% increase from the prior year, with most of the growth occurring in the first three quarters of the fiscal year. However, personal income growth slowed to an annualized rate of 2% by the final quarter of the 2005-06 fiscal year.

General Fund Budget Highlights

The original General Fund budget of $88.3 billion was increased by $5.2 billion, mainly due to a $1.2 billion transfer to a special revenue fund for transportation projects and $2.3 billion in increased funding to schools from the Proposition 98 funding guarantee, of which $650 million is for reimbursement of state mandated costs. During the 2005-06 fiscal year, General Fund actual expenditures were $92.1 billion, $1.4 billion less than the final budgeted amounts.

Table 3

General Fund Original and Final Budgets
Year ended June 30, 2006
(amounts in millions)

	Original	Final	Increase/ (Decrease)
Budgeted amounts			
State and consumer services	$ 550	$ 555	$ 5
Business and transportation	14	1,373	1,359
Resources	1,035	1,171	136
Health and human services	27,203	27,474	271
Correctional programs	7,273	7,725	452
Education	43,060	46,007	2,947
General government:			
Tax relief	2,009	2,005	(4)
Debt service	3,236	3,242	6
Other general government	3,900	3,922	22
Total	**$ 88,280**	**$ 93,474**	**$ 5,194**

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, 2006, amounted to $95.6 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, 2006
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Land	$ 15,150	$ 46	$ 15,196
State highway infrastructure	55,726	—	55,726
Collections – nondepreciable	20	—	20
Buildings and other depreciable property	20,790	8,327	29,117
Less: accumulated depreciation	(8,406)	(3,427)	(11,833)
Construction in progress	6,483	903	7,386
Total	**$ 89,763**	**$ 5,849**	**$ 95,612**

The budget authorized $1.6 billion for the State's capital outlay program in the 2005-06 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, $104 million was from the General Fund; $441 million was from lease-revenue bonds; $965 million was from proceeds of various general obligation bonds; and $70 million from reimbursements, federal funds, and special funds. The major capital projects authorized include:

- $910 million for numerous construction projects within the University of California, the California State University, and the California Community Colleges;
- $149 million for the Department of Forestry and Fire Protection to replace six fire stations and address other significant health and safety issues as well as critical infrastructure deficiencies at emergency response facilities; and
- $131 million for the Department of Corrections and Rehabilitation to meet licensing requirements and address safety and housing issues.

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 49,560 lane miles and 12,120 bridges.

During the 2005-06 fiscal year, the actual amount spent on preservation was 73.8% 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 assessed conditions of the State's bridges and roadways 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, 2006, the primary government had total bonded debt outstanding of $79.1 billion. Of this amount, $49.0 billion (61.9%) represents general obligation bonds, which are backed by the full faith and credit of the State. Included in the $49.0 billion of general obligation bonds is $9.9 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 $1.9 billion and the long-term portion is $47.1 billion. The remaining $30.1 billion (38.1%) 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 $29.1 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, 2006
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Government-wide noncurrent liabilities			
General obligation bonds	$ 45,211	$ 1,834	$ 47,045
Revenue bonds	7,201	21,869	29,070
Certificates of participation and commercial paper	342	231	573
Capital lease obligations	4,265	—	4,265
Other noncurrent liabilities	12,363	2,159	14,522
Total noncurrent liabilities	**69,382**	**26,093**	**95,475**
Current portion of long-term obligations	4,475	1,764	6,239
Total long-term obligations	**$ 73,857**	**$ 27,857**	**$ 101,714**

The primary government's total long-term obligations remained relatively unchanged during the year ended June 30, 2006. The largest change in governmental activities' long-term obligations is an increase of $2.8 billion in the Proposition 98 minimum funding guarantee related to a settlement reached with the California Teachers' Association.

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

As 2007 begins, economic forecasters are focusing on the soft real estate market. In December 2006, residential sales in California were down 22.2% from last December. Interestingly, the statewide median price paid for California housing was 3.5% higher in December 2005. However, some areas of the State are seeing price declines. San Diego is the largest county to experience a significant price decline, 6.4% from last year, and is being closely watched as a trendsetter. In a joint study by DataQuick and the California Association of Realtors, 53% of the 364 cities studied showed a price decline in housing. Building permits for residential units, a sign of future construction levels, were issued at an annualized rate of 134,000 units in December 2006; this is less than half the rate of the September 2005 peak. There is concern that the real estate slump could spill over to the rest of the economy, but so far the impact on other sectors has been limited and there are signs that the real estate slowdown is leveling out.

California's Future Budgets

California's 2006-07 Budget Act was enacted on June 30, 2006. The total spending plan adopted for the State was $131.4 billion, including the General Fund, special funds, and bond funds. The General Fund's available resources and expenditures were projected to be $103.4 billion and $101.3 billion, respectively. The adopted budget set aside a total of $4.9 billion to increase General Fund reserves and pay down debt. A total of $2.8 billion was dedicated to pre-pay general obligation debt, repay various loans from special funds, and reimburse local governments for costs incurred to perform state-mandated programs. The adopted budget authorized a $2.1 billion year-end reserve (Reserve for Economic Uncertainties of $1.6 billion and $472 million in the Budget Stabilization Account).

General Fund revenues come predominately from taxes, with personal income taxes expected to provide 54% of the revenues. California's major taxes (personal income, sales, and corporation taxes) are projected to supply approximately 95% of the General Fund's budgeted resources in the 2006-07 fiscal year.

Governor's Proposed Budget for 2007-08

The Governor released his proposed budget on January 10, 2007. The 2007-08 proposed spending plan totals $143.4 billion. This spending plan represents estimated General Fund expenditures of $103.1 billion, special fund expenditures of $27.7 billion, and bond fund expenditures of $12.6 billion. Proposed General Fund expenditures are 1.0% higher than the $102.1 billion expenditures estimated for the 2006-07 fiscal year.

The Governor's budget projects to end the 2007-08 fiscal year with a $2.1 billion General Fund reserve, including $1.5 billion in the Budget Stabilization Account. Proposition 58, passed by California's voters in 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. However, this transfer can be suspended by action of the Governor by June of the preceding fiscal year.

In the 2007-08 *Overview of the Governor's Budget*, the Legislative Analyst's Office, California's nonpartisan fiscal and policy advisor, states that the Governor's budget assumptions on the fiscal benefits of solutions (savings totaling $3.4 billion) and the outcomes of legal cases appear optimistic and may make implementation

of the proposed budget problematic. The proposed budget continues to demonstrate an annual operating shortfall, whereby the General Fund's operating expenses exceed its revenue.

Proposed budget solutions include reducing General Fund expenditures by $1.1 billion while using other funds to support home-to-school transportation costs, general obligation bonded debt costs, and developmental services. Other solutions include an estimated $506 million in new revenues from tribal gaming compacts, California Work Opportunity and Responsibility to Kids (CalWORKS) savings related to the suspension of cost-of-living adjustments, and using bond funds for General Fund flood protection expenditures. Another $1.2 billion is estimated from lower baseline expenditures, including the administration's projection of higher local property taxes that would reduce the General Fund's spending on schools under the Proposition 98 minimum-funding guarantee. Lastly, the State would need to prevail in the appellate court on two key court decisions to avoid spending an additional $1.1 billion on pension costs and cost-of-living adjustment on CalWORKS grants.

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

Government-wide Financial Statements

Statement of Net Assets

June 30, 2006
(amounts in thousands)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Current assets:				
Cash and pooled investments	$ 24,716,323	$ 5,863,863	$ 30,580,186	$ 2,501,603
Amount on deposit with U.S. Treasury	—	2,845,412	2,845,412	—
Investments	1,399,654	434,614	1,834,268	12,950,423
Restricted assets:				
Cash and pooled investments	—	1,695,765	1,695,765	11,902
Investments	—	—	—	52,943
Due from other governments	—	58,300	58,300	—
Net investment in direct financing leases	—	306,488	306,488	—
Receivables (net)	10,176,978	536,559	10,713,537	3,803,268
Internal balances	128,153	(128,153)	—	—
Due from primary government	—	—	—	169,502
Due from other governments	9,947,176	201,364	10,148,540	651,067
Prepaid items	47,240	7,330	54,570	7,083
Inventories	45,248	26,418	71,666	129,503
Recoverable power costs (net)	—	613,000	613,000	—
Other current assets	309,942	5,134	315,076	177,809
Total current assets	46,770,714	12,466,094	59,236,808	20,455,103
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	1,339,092	1,339,092	115,502
Investments	—	683,066	683,066	87,508
Loans receivable	—	569,003	569,003	—
Investments	—	1,784,519	1,784,519	33,216,284
Net investment in direct financing leases	—	6,154,395	6,154,395	—
Receivables (net)	1,209,397	30,503	1,239,900	881,827
Loans receivable	1,999,845	3,078,586	5,078,431	6,217,156
Recoverable power costs (net)	—	7,229,000	7,229,000	—
Deferred charges	259,634	1,345,233	1,604,867	58,273
Capital assets:				
Land	15,150,360	45,784	15,196,144	666,904
State highway infrastructure	55,725,491	—	55,725,491	—
Collections – nondepreciable	20,417	—	20,417	258,378
Buildings and other depreciable property	20,789,934	8,327,033	29,116,967	25,590,366
Less: accumulated depreciation	(8,406,276)	(3,426,467)	(11,832,743)	(11,751,446)
Construction in progress	6,483,154	902,625	7,385,779	3,234,846
Other noncurrent assets	—	4,231	4,231	1,563,492
Total noncurrent assets	93,231,956	28,066,603	121,298,559	60,139,090
Total assets	**$ 140,002,670**	**$ 40,532,697**	**$ 180,535,367**	**$ 80,594,193**

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

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
LIABILITIES				
Current liabilities:				
Accounts payable	$ 14,577,297	$ 536,588	$ 15,113,885	$ 1,959,396
Due to component units	157,332	12,170	169,502	—
Due to other governments	7,205,900	94,034	7,299,934	1,418
Dividends payable	—	—	—	3,100
Deferred revenue	—	55,074	55,074	737,738
Tax overpayments	4,148,462	—	4,148,462	—
Deposits	230,358	3,301	233,659	489,058
Contracts and notes payable	50,946	2,000	52,946	10,419
Advance collections	593,389	26,030	619,419	229,137
Interest payable	742,108	185,674	927,782	126,856
Securities lending obligations	—	—	—	5,018,638
Benefits payable	—	347,530	347,530	3,662,040
Current portion of long-term obligations	4,474,559	1,763,835	6,238,394	2,401,185
Other current liabilities	1,230,731	70,633	1,301,364	1,358,007
Total current liabilities	33,411,082	3,096,869	36,507,951	15,996,992
Noncurrent liabilities:				
Loans payable	1,054,674	—	1,054,674	9,078
Benefits payable	—	14,008	14,008	16,356,886
Lottery prizes and annuities	—	1,559,298	1,559,298	—
Compensated absences payable	1,675,006	24,792	1,699,798	276,915
Certificates of participation, commercial paper, and other borrowings	341,896	231,121	573,017	153,417
Capital lease obligations	4,265,200	—	4,265,200	2,110,184
General obligation bonds payable	45,211,387	1,833,945	47,045,332	—
Revenue bonds payable	7,200,643	21,869,598	29,070,241	13,009,259
Other noncurrent liabilities	9,633,213	560,492	10,193,705	1,668,844
Total noncurrent liabilities	69,382,019	26,093,254	95,475,273	33,584,583
Total liabilities	**102,793,101**	**29,190,123**	131,983,224	**49,581,575**
NET ASSETS				
Investment in capital assets, net of related debt	83,489,137	818,405	84,307,542	9,203,956
Restricted:				
Nonexpendable – endowments	—	—	—	2,980,295
Expendable:				
Endowments and gifts	—	—	—	6,381,323
Business and transportation	881,474	128,574	1,010,048	1,267,313
Resources	1,747,984	1,651,228	3,399,212	—
Health and human services	1,819,875	89,308	1,909,183	—
Education	1,206,333	495,486	1,701,819	1,543,361
General government	2,708,331	620,024	3,328,355	743,024
Unemployment programs	67,282	5,738,245	5,805,527	—
Workers' compensation liability	—	—	—	3,280,285
Total expendable	8,431,279	8,722,865	17,154,144	13,215,306
Unrestricted	(54,710,847)	1,801,304	(52,909,543)	5,613,061
Total net assets	**37,209,569**	**11,342,574**	48,552,143	**31,012,618**
Total liabilities and net assets	**$ 140,002,670**	**$ 40,532,697**	$ 180,535,367	**$ 80,594,193**

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

Statement of Activities

Year Ended June 30, 2006
(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	$ 9,674,816	$ 4,614,567	$ 1,052,381	$ —
Education	62,652,997	3,360,919	6,644,942	—
Health and human services	65,763,380	4,554,673	32,658,966	—
Resources	4,161,814	2,198,886	69,348	—
State and consumer services	595,602	640,088	29,873	—
Business and transportation	8,809,236	3,776,098	1,689,809	1,272,506
Correctional programs	7,299,124	37,203	108,746	—
Tax relief	704,306	5,463	—	—
Interest on long-term debt	2,893,537	—	—	—
Total governmental activities	162,554,812	19,187,897	42,254,065	1,272,506
Business-type activities:				
Electric Power	5,342,000	5,342,000	—	—
Water Resources	949,691	949,691	—	—
Public Building Construction	334,094	384,442	—	—
State Lottery	3,911,717	3,740,041	—	—
Unemployment Programs	8,584,521	10,263,447	—	—
High Technology Education	30,871	26,508	—	—
Toll Facilities	18,265	21	—	—
State University Dormitory Building Maintenance and Equipment	491,914	512,231	—	—
State Water Pollution Control Revolving	20,427	64,740	—	56,942
Housing Loan	138,988	127,733	—	—
Other enterprise programs	113,976	129,048	—	—
Total business-type activities	19,936,464	21,539,902	—	56,942
Total primary government	**$ 182,491,276**	**$ 40,727,799**	**$ 42,254,065**	**$ 1,329,448**
Component units:				
University of California	$ 20,293,238	$ 12,116,518	$ 7,067,721	$ 166,502
State Compensation Insurance Fund	6,023,356	5,946,401	—	—
California Housing Finance Agency	512,786	10,970	115,745	—
Public Employees' Benefit Fund	3,164,569	3,102,717	—	—
Nonmajor component units	1,922,969	1,088,497	523,518	8,309
Total component units	**$ 31,916,918**	**$ 22,265,103**	**$ 7,706,984**	**$ 174,811**

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

Transfers

Special item**

Total general and other revenues and transfers

Change in net assets

Net assets, July 1, 2005

Net assets, June 30, 2006

* Restated

** A related organization assumed debt on the State's behalf; refer to Note 16, Revenue Bonds.

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
$ (4,007,868)		$ (4,007,868)	
(52,647,136)		(52,647,136)	
(28,549,741)		(28,549,741)	
(1,893,580)		(1,893,580)	
74,359		74,359	
(2,070,823)		(2,070,823)	
(7,153,175)		(7,153,175)	
(698,843)		(698,843)	
(2,893,537)		(2,893,537)	
(99,840,344)		(99,840,344)	
	$ —	—	
	—	—	
	50,348	50,348	
	(171,676)	(171,676)	
	1,678,926	1,678,926	
	(4,363)	(4,363)	
	(18,244)	(18,244)	
	20,317	20,317	
	101,255	101,255	
	(11,255)	(11,255)	
	15,072	15,072	
	1,660,380	1,660,380	
(99,840,344)	**1,660,380**	(98,179,964)	
			$ (942,497)
			(76,955)
			(386,071)
			(61,852)
			(302,645)
			(1,770,020)
51,251,266	—	51,251,266	—
34,162,177	—	34,162,177	—
10,735,792	—	10,735,792	—
2,212,916	—	2,212,916	—
2,099,075	—	2,099,075	—
504,655	—	504,655	2,195,211
291,549	—	291,549	—
—	—	—	2,147,766
23,259	(23,259)	—	—
1,218,311	—	1,218,311	—
102,499,000	**(23,259)**	102,475,741	**4,342,977**
2,658,656	1,637,121	4,295,777	2,572,957
34,550,913 *	**9,705,453** *	44,256,366	**28,439,661** *
$ 37,209,569	**$ 11,342,574**	$ 48,552,143	**$ 31,012,618**

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

Fund Financial Statements

Balance Sheet

Governmental Funds

June 30, 2006
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
ASSETS					
Cash and pooled investments	$ 11,663,245	$ 465,273	$ 1,275,847	$ 10,710,394	$ 24,114,759
Investments	—	—	—	1,399,654	1,399,654
Receivables (net)	8,086,204	76,666	396,365	1,335,800	9,895,035
Due from other funds	927,328	354	1,747,957	1,692,236	4,367,875
Due from other governments	938,933	8,808,357	5,963	179,448	9,932,701
Interfund receivables	52,905	—	492,900	1,961,781	2,507,586
Loans receivable	99,640	40,986	—	1,823,878	1,964,504
Other assets	40,563	—	112,088	75,364	228,015
Total assets	**$ 21,808,818**	**$ 9,391,636**	**$ 4,031,120**	**$ 19,178,555**	$ 54,410,129
LIABILITIES					
Accounts payable	$ 1,539,773	$ 1,546,275	$ 124,700	$ 3,003,278	$ 6,214,026
Due to other funds	4,995,798	5,835,854	21,374	1,182,797	12,035,823
Due to component units	90,453	—	—	59,973	150,426
Due to other governments	4,598,444	1,908,955	281,311	1,754,039	8,542,749
Interfund payables	3,015,235	—	—	506,749	3,521,984
Tax overpayments	4,141,413	—	—	7,049	4,148,462
Deposits	5,822	—	8,709	215,067	229,598
Contracts and notes payable	—	—	—	42,196	42,196
Advance collections	29,017	40,179	4,923	281,285	355,404
Interest payable	5,526	9,878	—	210,836	226,240
General obligation bonds payable	—	—	—	173,540	173,540
Other liabilities	714,522	16,055	218,810	638,106	1,587,493
Total liabilities	**19,136,003**	**9,357,196**	**659,827**	**8,074,915**	37,227,941
FUND BALANCES					
Reserved for:					
Encumbrances	608,152	—	1,658,430	3,081,356	5,347,938
Interfund receivables	52,905	—	492,900	1,961,781	2,507,586
Loans receivable	99,640	40,986	—	1,823,878	1,964,504
Continuing appropriations	1,239,256	—	3,829,889	2,703,340	7,772,485
Debt service	—	—	—	605,921	605,921
Unreserved, reported in:					
General Fund	672,862	—	—	—	672,862
Special revenue funds	—	(6,546)	(2,609,926)	1,809,914	(806,558)
Capital projects funds	—	—	—	(882,550)	(882,550)
Total fund balances	**2,672,815**	**34,440**	**3,371,293**	**11,103,640**	17,182,188
Total liabilities and fund balances	**$ 21,808,818**	**$ 9,391,636**	**$ 4,031,120**	**$ 19,178,555**	

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		**$ 17,182,188**
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.		89,338,482
• Other long-term assets are not available to pay for current-period expenditures and, therefore, are not reported.		1,209,397
• 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.		665,880
• 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.		259,634
• General obligation bonds totaling $47,346,145 and revenue bonds totaling $7,300,638 are not due and payable in the current period and, therefore, are not reported in the funds.		(54,646,783)
• Certain long-term liabilities are not due and payable in the current period; therefore, adjustments to these liabilities are not reported in the funds:		
Compensated absences adjustments	(1,714,105)	
Certificates of participation and commercial paper adjustments	(923,890)	
Capital lease adjustments	(4,454,707)	
Other long-term obligations	(9,706,527)	
		(16,799,229)
Net assets of governmental activities		**$ 37,209,569**

Statement of Revenues, Expenditures, and Changes in Fund Balances

Governmental Funds

Year Ended June 30, 2006 (amounts in thousands)	General	Federal	Transportation Construction	Nonmajor Governmental	Total
REVENUES					
Personal income taxes	$ 49,903,435	$ —	$ —	$ 894,983	$ 50,798,418
Sales and use taxes	27,613,417	—	2,478,510	4,208,475	34,300,402
Corporation taxes	10,709,792	—	—	—	10,709,792
Insurance taxes	2,212,916	—	—	—	2,212,916
Other taxes	458,644	—	—	1,909,026	2,367,670
Intergovernmental	—	43,507,965	—	1,958,220	45,466,185
Licenses and permits	47,286	—	949,166	4,128,771	5,125,223
Charges for services	193,390	—	95,370	713,650	1,002,410
Fees	577,635	—	—	4,737,468	5,315,103
Penalties	65,399	1,496	—	626,308	693,203
Investment and interest	458,406	—	68,333	531,380	1,058,119
Escheat	291,549	—	—	—	291,549
Other	880,915	—	64,009	3,573,697	4,518,621
Total revenues	**93,412,784**	**43,509,461**	**3,655,388**	**23,281,978**	163,859,611
EXPENDITURES					
Current:					
General government	2,427,166	1,100,295	9,214	5,047,397	8,584,072
Education	46,649,106	6,974,878	980	6,143,713	59,768,677
Health and human services	26,157,469	31,252,257	—	8,558,707	65,968,433
Resources	1,002,126	184,176	17	3,110,396	4,296,715
State and consumer services	484,488	29,919	—	596,721	1,111,128
Business and transportation	245,711	2,879,845	4,403,909	2,841,124	10,370,589
Correctional programs	7,528,417	22,899	—	1,474	7,552,790
Tax relief	810,236	—	—		810,236
Capital outlay	748,037	—	—	1,380,013	2,128,050
Debt service:					
Bond and commercial paper retirement	1,380,372	47,845	—	4,947,390	6,375,607
Interest and fiscal charges	1,763,830	24,493	60,148	1,287,292	3,135,763
Total expenditures	**89,196,958**	**42,516,607**	**4,474,268**	**33,914,227**	170,102,060
Excess (deficiency) of revenues over (under) expenditures	4,215,826	992,854	(818,880)	(10,632,249)	(6,242,449)
OTHER FINANCING SOURCES (USES)					
General obligation bonds and commercial paper issued	—	—	—	7,750,500	7,750,500
Refunding bonds issued	—	—	2,555	5,084,389	5,086,944
Payment to refunding agent	—	—	(2,555)	(4,559,389)	(4,561,944)
Capital leases	748,037	—	—		748,037
Transfers in	725,629	—	488,215	3,924,051	5,137,895
Transfers out	(3,203,534)	(985,442)	(2,108)	(922,023)	(5,113,107)
Total other financing sources (uses)	**(1,729,868)**	**(985,442)**	**486,107**	**11,277,528**	9,048,325
Net change in fund balances	2,485,958	7,412	(332,773)	645,279	2,805,876
Fund balances, July 1, 2005	**186,857**	**27,028**	**3,704,066** *	**10,458,361** *	14,376,312
Fund balances, June 30, 2006	**$ 2,672,815**	**$ 34,440**	**$ 3,371,293**	**$ 11,103,640**	$ 17,182,188

* 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		**$ 2,805,876**
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.		2,575,851
• Revenues in the Statement of Activities that do not provide current financial resources are deferred and not reported as revenues in the funds.		112,288
• 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	(1,125,862)	
Revenue bond adjustments	768,342	
Certificates of participation and commercial paper adjustments	(171,877)	
		(529,397)
• 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	(132,631)	
Lease adjustments	(541,234)	
Other long-term obligations	(1,682,344)	
		(2,356,209)
• 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.		50,247
Change in net assets of governmental activities		**$ 2,658,656**

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

Statement of Net Assets

Proprietary Funds

June 30, 2006
(amounts in thousands)

	Electric Power	Water Resources
ASSETS		
Current assets:		
Cash and pooled investments	$ 5,000	$ 295,326
Amount on deposit with U.S. Treasury	—	—
Investments	70,000	—
Restricted assets:		
Cash and pooled investments	1,464,000	—
Due from other governments	—	—
Net investment in direct financing leases	—	—
Receivables (net)	—	109,952
Due from other funds	33,000	5,349
Due from other governments	—	7,495
Prepaid items	—	—
Inventories	—	13,450
Recoverable power costs (net)	613,000	—
Other current assets	—	100
Total current assets	2,185,000	431,672
Noncurrent assets:		
Restricted assets:		
Cash and pooled investments	901,000	170,834
Investments	600,000	48,553
Loans receivable	—	—
Investments	—	—
Net investment in direct financing leases	—	—
Receivables	—	—
Interfund receivables	—	91,517
Loans receivable	—	26,403
Recoverable power costs (net)	7,229,000	—
Deferred charges	—	1,233,507
Capital assets:		
Land	—	—
Buildings and other depreciable property	—	4,566,362
Less: accumulated depreciation	—	(1,722,093)
Construction in progress	—	176,333
Other noncurrent assets	—	—
Total noncurrent assets	8,730,000	4,591,416
Total assets	**$ 10,915,000**	**$ 5,023,088**

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**
$ —	$ 366,662	$ 3,057,211	$ 2,139,664	$ 5,863,863	$ 601,570
—	—	2,845,412	—	2,845,412	—
—	340,053	—	24,561	434,614	—
103,274	—	—	128,491	1,695,765	—
—	—	—	58,300	58,300	—
288,296	—	—	18,192	306,488	—
126,480	228,844	156,814	44,188	666,278	149,458
47,861	5,640	36,927	27,729	156,506	356,903
—	18,348	69,722	105,799	201,364	14,475
—	7,272	—	58	7,330	47,240
—	9,003	—	3,965	26,418	45,248
—	—	—	—	613,000	—
—	—	—	5,034	5,134	48,375
565,911	975,822	6,166,086	2,555,981	12,880,472	1,263,269
266,361	—	—	897	1,339,092	—
—	—	—	34,513	683,066	—
—	—	—	569,003	569,003	—
—	1,657,839	—	126,680	1,784,519	—
5,826,034	—	—	328,361	6,154,395	—
—	—	30,503	—	30,503	—
—	—	—	2,246	93,763	—
—	—	—	3,052,183	3,078,586	—
—	—	—	—	7,229,000	—
64,643	17,549	—	29,534	1,345,233	—
—	4,923	—	40,861	45,784	231
—	82,234	14,628	3,663,809	8,327,033	1,145,688
—	(44,230)	(5,165)	(1,654,979)	(3,426,467)	(724,845)
389,149	—	—	337,143	902,625	3,524
—	—	—	4,231	4,231	—
6,546,187	1,718,315	39,966	6,534,482	28,160,366	424,598
$ 7,112,098	**$ 2,694,137**	**$ 6,206,052**	**$ 9,090,463**	$ 41,040,838	**$ 1,687,867**

(continued)

Statement of Net Assets (continued)

Proprietary Funds

June 30, 2006
(amounts in thousands)

	Electric Power	Water Resources
LIABILITIES		
Current liabilities:		
Accounts payable	$ 394,000	$ 69,733
Due to other funds	—	7,549
Due to component units	—	—
Due to other governments	—	81,535
Deferred revenue	—	—
Deposits	—	—
Contracts and notes payable	—	—
Advance collections	—	—
Interest payable	56,000	19,713
Benefits payable	—	—
Current portion of long-term obligations	470,000	138,014
Other current liabilities	—	—
Total current liabilities	920,000	316,544
Noncurrent liabilities:		
Interfund payables	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	—
Certificates of participation, commercial paper, and other borrowings	—	128,741
Capital lease obligations	—	—
General obligation bonds payable	—	634,750
Revenue bonds payable	9,995,000	2,318,473
Other noncurrent liabilities	—	419,149
Total noncurrent liabilities	9,995,000	3,501,113
Total liabilities	**10,915,000**	**3,817,657**
NET ASSETS		
Investment in capital assets, net of related debt	—	224,246
Restricted – Expendable:		
Construction	—	981,185
Debt service	—	—
Security for revenue bonds	—	—
Lottery	—	—
Unemployment program	—	—
Other purposes	—	—
Total expendable	—	981,185
Unrestricted	—	—
Total net assets	**—**	**1,205,431**
Total liabilities and net assets	**$ 10,915,000**	**$ 5,023,088**

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**
$ 4,072	$ 35,782	$ 17	$ 22,134	$ 525,738	$ 161,727
90,697	323,263	23,037	71,484	516,030	409,341
5,148	—	—	7,022	12,170	6,906
945	—	10,773	781	94,034	171
—	—	—	55,074	55,074	—
—	—	—	3,301	3,301	760
—	—	—	2,000	2,000	8,750
19,084	2,934	—	4,012	26,030	237,985
63,159	—	—	46,802	185,674	—
—	—	347,530	—	347,530	—
324,630	661,766	—	169,425	1,763,835	20,404
—	—	69,205	1,428	70,633	3,251
507,735	1,023,745	450,562	383,463	3,602,049	849,295
—	—	—	2,961	2,961	95,737
—	—	—	14,008	14,008	—
—	1,559,298	—	—	1,559,298	—
—	4,821	7,736	12,235	24,792	44,082
—	—	—	102,380	231,121	—
—	—	—	—	—	10,015
—	—	—	1,199,195	1,833,945	—
6,438,926	—	—	3,117,199	21,869,598	—
—	2,042	—	139,301	560,492	22,857
6,438,926	1,566,161	7,736	4,587,279	26,096,215	172,691
6,946,661	**2,589,906**	**458,298**	**4,970,742**	29,698,264	**1,021,986**
—	42,927	9,509	541,723	818,405	399,189
141,968	—	—	445,946	1,569,099	—
23,469	—	—	138,165	161,634	—
—	—	—	627,303	627,303	—
—	104,231	—	—	104,231	—
—	—	5,738,245	—	5,738,245	—
—	—	—	522,353	522,353	—
165,437	104,231	5,738,245	1,733,767	8,722,865	—
—	(42,927)	—	1,844,231	1,801,304	266,692
165,437	**104,231**	**5,747,754**	**4,119,721**	11,342,574	**665,881**
$ 7,112,098	**$ 2,694,137**	**$ 6,206,052**	**$ 9,090,463**	$ 41,040,838	**$ 1,687,867**

(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, 2006
(amounts in thousands)

	Electric Power	Water Resources
OPERATING REVENUES		
Unemployment and disability insurance	$ —	$ —
Lottery ticket sales	—	—
Power sales	4,370,000	291,793
Student tuition and fees	—	—
Services and sales	—	657,898
Investment and interest	—	—
Rent	—	—
Other	—	—
Total operating revenues	**4,370,000**	**949,691**
OPERATING EXPENSES		
Lottery prizes	—	—
Power purchases (net of recoverable power costs)	4,337,000	330,665
Personal services	—	185,503
Supplies	—	—
Services and charges	33,000	189,535
Depreciation	—	77,980
Distributions to beneficiaries	—	—
Interest expense	—	—
Amortization of deferred charges	—	—
Other	—	—
Total operating expenses	**4,370,000**	**783,683**
Operating income (loss)	—	166,008
NONOPERATING REVENUES (EXPENSES)		
Investment and interest income	972,000	—
Interest expense and fiscal charges	(972,000)	(150,170)
Lottery payments for education	—	—
Other	—	(15,838)
Total nonoperating revenues (expenses)	**—**	**(166,008)**
Income (loss) before contributions and transfers	—	—
Capital contributions	—	—
Transfers in	—	—
Transfers out	—	—
Change in net assets	—	—
Total net assets, July 1, 2005	**—**	**1,205,431**
Total net assets, June 30, 2006	**$ —**	**$ 1,205,431**

* Restated

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**
$ —	$ —	$ 9,930,563	$ —	$ 9,930,563	$ —
—	3,584,996	—	—	3,584,996	—
—	—	—	—	4,661,793	—
—	—	—	455,176	455,176	—
—	—	128,915	91,142	877,955	2,245,901
27,866	—	—	169,028	196,894	152
356,520	—	—	51,422	407,942	—
56	—	—	17,412	17,468	—
384,442	**3,584,996**	**10,059,478**	**784,180**	20,132,787	**2,246,053**
—	1,932,721	—	—	1,932,721	—
—	—	—	—	4,667,665	—
—	41,201	126,532	148,100	501,336	641,461
—	16,125	—	—	16,125	8,962
9,832	346,992	64,950	240,376	884,685	1,468,437
—	8,710	589	122,659	209,938	82,018
—	—	8,392,450	—	8,392,450	—
317,282	—	—	233,886	551,168	905
6,980	35	—	168	7,183	—
—	—	—	59,267	59,267	—
334,094	**2,345,784**	**8,584,521**	**804,456**	17,222,538	**2,201,783**
50,348	1,239,212	1,474,957	(20,276)	2,910,249	44,270
—	154,192	203,969	75,161	1,405,322	4,598
—	(307,425)	—	(9,857)	(1,439,452)	(28)
—	(1,258,508)	—	—	(1,258,508)	—
—	853	—	812	(14,173)	(222)
—	**(1,410,888)**	**203,969**	**66,116**	(1,306,811)	**4,348**
50,348	(171,676)	1,678,926	45,840	1,603,438	48,618
—	—	—	56,942	56,942	3,053
25,070	—	11,944	7,870	44,884	227
(6,584)	—	—	(61,559)	(68,143)	(1,651)
68,834	(171,676)	1,690,870	49,093	1,637,121	50,247
96,603	**275,907**	**4,056,884**	**4,070,628** *	9,705,453	**615,634**
$ 165,437	**$ 104,231**	**$ 5,747,754**	**$ 4,119,721**	$ 11,342,574	**$ 665,881**

Statement of Cash Flows

Proprietary Funds

Year Ended June 30, 2006
(amounts in thousands)

	Electric Power	Water Resources
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers/employers	$ 4,350,000	$ 967,872
Receipts from interfund services provided	—	—
Payments to suppliers	(5,097,000)	(450,074)
Payments to employees	—	(185,503)
Payments for interfund services used	—	—
Payments for Lottery prizes	—	—
Claims paid to other than employees	—	—
Other receipts (payments)	288,000	(23,746)
Net cash provided by (used in) operating activities	**(459,000)**	**308,549**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Proceeds from bonds	3,392,000	—
Retirement of general obligation bonds	—	—
Retirement of revenue bonds	(3,064,000)	—
Interest paid on operating debt	(466,000)	—
Transfers in	—	—
Transfers out	—	—
Grants received	—	—
Lottery payments for education	—	—
Net cash provided by (used in) noncapital financing activities	**(138,000)**	**—**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Acquisition of intangible assets	—	—
Acquisition of capital assets	—	(124,457)
Proceeds from sale of capital assets	—	—
Proceeds from notes payable and commercial paper	—	127,008
Principal paid on notes payable and commercial paper	—	(12,413)
Payment of capital lease obligations	—	—
Retirement of general obligation bonds	—	(47,575)
Proceeds from revenue bonds	—	116,207
Retirement of revenue bonds	—	(152,075)
Interest paid	—	(151,166)
Contributed capital	—	—
Net cash provided by (used in) capital and related financing activities	**—**	**(244,471)**
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	—	—
Proceeds from maturity and sale of investments	—	—
Change in interfund receivables and loans receivable	—	1,981
Earnings on investments	128,000	17,099
Net cash provided by (used in) investing activities	**128,000**	**19,080**
Net increase (decrease) in cash and pooled investments	(469,000)	83,158
Cash and pooled investments at July 1, 2005	**2,839,000** *	**383,002**
Cash and pooled investments at June 30, 2006	**$ 2,370,000**	**$ 466,160**

* Restated

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
$ 607,947	$ 3,522,285	$ 10,084,551	$ 633,335	$ 20,165,990	$ 2,270,631
—	—	—	13,676	13,676	41,870
(9,373)	(117,812)	(64,950)	(305,216)	(6,044,425)	(1,426,901)
—	(36,582)	(126,918)	(138,165)	(487,168)	(609,797)
—	(8,240)	—	(18,212)	(26,452)	(18,044)
—	(2,394,163)	—	—	(2,394,163)	—
—	(252,539)	(8,415,186)	(63)	(8,667,788)	(8,800)
(307,483)	231,265	(196,512)	(15,721)	(24,197)	(49,166)
291,091	**944,214**	**1,280,985**	**169,634**	2,535,473	**199,793**
—	—	—	(309)	(309)	(891)
—	—	—	56,050	3,448,050	—
—	—	—	(104,940)	(104,940)	—
—	—	—	(22,185)	(3,086,185)	—
—	—	—	(11,597)	(477,597)	(28)
911,843	—	11,944	14,492	938,279	—
(893,357)	—	—	(46,447)	(939,804)	(465)
—	—	—	55,179	55,179	—
—	(1,244,619)	—	—	(1,244,619)	—
18,486	**(1,244,619)**	**11,944**	**(59,757)**	(1,411,946)	**(1,384)**
6,394	—	—	—	6,394	—
—	—	—	—	—	(5,257)
(553,373)	(10,753)	(671)	(220,330)	(909,584)	(101,523)
—	3	—		3	416
—	—	—	—	127,008	—
—	—	—	—	(12,413)	(1,928)
—	—	—	—	—	(232)
—	—	—	—	(47,575)	—
410,222	—	—	524,738	1,051,167	—
(332,345)	—	—	(146,264)	(630,684)	—
—	—	—	(91,876)	(243,042)	(905)
—	—	—	—	—	3,053
(469,102)	**(10,750)**	**(671)**	**66,268**	(658,726)	**(106,376)**
—	(398,581)	(973,198)	(4,407)	(1,376,186)	—
—	733,569	—	2,847	736,416	—
—	—	—	(66)	1,915	—
—	16,184	203,969	67,167	432,419	4,610
—	**351,172**	**(769,229)**	**65,541**	(205,436)	**4,610**
(159,525)	40,017	523,029	241,686	259,365	96,643
529,160	**326,645**	**2,534,182**	**2,027,366**	8,639,355	**504,927**
$ 369,635	**$ 366,662**	**$ 3,057,211**	**$ 2,269,052**	$ 8,898,720	**$ 601,570**

(continued)

Statement of Cash Flows (continued)

Proprietary Funds

Year Ended June 30, 2006
(amounts in thousands)

	Electric Power	Water Resources
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Operating income (loss)	$ —	$ 166,008
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:		
Interest expense on operating debt	—	—
Depreciation	—	77,980
Accretion of capital appreciation bonds	—	—
Provisions and allowances	—	—
Accrual of deferred charges	—	—
Amortization of discounts	—	—
Amortization of deferred charges	—	113,097
Other	—	—
Change in assets and liabilities:		
Receivables	—	(13,255)
Due from other funds	—	—
Due from other governments	—	(287)
Prepaid items	—	—
Inventories	—	(3,497)
Net investment in direct financing leases	—	—
Recoverable power costs (net)	(429,000)	—
Other current assets	—	(97)
Loans receivable	—	—
Interfund receivable	—	—
Accounts payable	(30,000)	21,527
Due to other funds	—	(43,090)
Due to component units	—	—
Due to other governments	—	8,105
Deposits	—	—
Contracts and notes payable	—	—
Advance collections	—	—
Interest payable	—	—
Other current liabilities	—	(23,746)
Interfund payables	—	—
Deferred revenue	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	5,804
Capital lease obligations	—	—
Other noncurrent liabilities	—	—
Total adjustments	(459,000)	142,541
Net cash provided by (used in) operating activities	**$ (459,000)**	**$ 308,549**
Noncash capital and related financing and investing activities		
Interest accreted on annuitized prizes	$ —	$ —
Unclaimed Lottery prizes directly transferred to Education Fund	—	—
Unrealized loss 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**
$ 50,348	$ 1,239,212	$ 1,474,957	$ (20,276)	$ 2,910,249	$ 44,270
—	—	—	—	—	905
—	8,710	589	122,659	209,938	82,018
2,345	—	—	2,846	5,191	—
—	6,832	—	(450)	6,382	—
(11,813)	—	—	29	(11,784)	—
(12,214)	—	—	427	(11,787)	—
10,876	35	—	7,260	131,268	—
—	934	—	67,414	68,348	140
—	(82,958)	(696)	17,516	(79,393)	(65,924)
(29,382)	18,862	(16,728)	(4,700)	(31,948)	17,197
—	(18,348)	23,403	(1,868)	2,900	(78,502)
—	4,361	—	1,193	5,554	(16,616)
—	(805)	—	(147)	(4,449)	(3,482)
281,126	—	—	18,755	299,881	—
—	—	—	—	(429,000)	—
—	(482)	—	(4,971)	(5,550)	16,144
—	—	—	(1,827)	(1,827)	—
—	—	—	130	130	—
(38)	(639)	10	(10,266)	(19,406)	(13,537)
(215)	132	(179,787)	(14,288)	(237,248)	154,295
—	—	—	7,022	7,022	(4,755)
406	—	(1,068)	(8,761)	(1,318)	166
—	—	—	(593)	(593)	(2,890)
—	—	—	2,000	2,000	(857)
(5,552)	52	—	(1,080)	(6,580)	64,543
5,205	—	—	2,898	8,103	—
(1)	—	2,359	(5,037)	(26,425)	(2,838)
—	—	—	(54)	(54)	—
—	—	—	3,736	3,736	—
—	175	(21,668)	(2,576)	(24,069)	—
—	(231,859)	—	—	(231,859)	—
—	—	(386)	(7,191)	(1,773)	2,487
—	—	—	—	—	7,552
—	—	—	(166)	(166)	(523)
240,743	(294,998)	(193,972)	189,910	(374,776)	155,523
$ 291,091	**$ 944,214**	**$ 1,280,985**	**$ 169,634**	$ 2,535,473	**$ 199,793**
					(concluded)
$ —	$ 135,749	$ —	$ —	$ 135,749	$ —
—	29,490	—	—	29,490	—
—	(171,676)	—	—	(171,676)	—

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, 2006
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment	Agency
ASSETS				
Cash and pooled investments	$ 45,935	$ 1,272,914	$ 16,505,617	$ 3,769,978
Investments, at fair value:				
Short-term	—	3,980,431	—	—
Equity securities	—	221,799,577	—	—
Debt securities	—	84,551,889	—	—
Real estate	—	27,044,181	—	—
Other	2,098,640	26,874,550	—	—
Securities lending collateral	—	65,637,546	—	—
Total investments	2,098,640	429,888,174	—	—
Receivables (net)	2,495	6,885,450	72,714	640,968
Due from other funds	64,322	416,146	—	7,732,192
Due from other governments	—	—	—	66,911
Prepaid Items	—	—	—	29,877
Interfund receivables	1,054,674	—	—	—
Loans receivable	—	—	—	44,600
Other assets	70,895	393,267	—	308
Total assets	**3,336,961**	**438,855,951**	**16,578,331**	**$ 12,284,834**
LIABILITIES				
Accounts payable	2,746	4,556,995	35	$ 4,141,184
Due to other funds	79	132,459	212	—
Due to other governments	—	53,488	186,199	6,626,079
Tax overpayments	—	—	—	6,601
Benefits payable	—	252,653	—	—
Deposits	70,895	—	—	931,323
Advance collections	—	—	—	61,340
Securities lending obligations	—	65,637,546	—	—
Interfund payables	—	—	—	35,341
Other liabilities	1,162,537	5,358,745	—	482,966
Total liabilities	**1,236,257**	**75,991,886**	**186,446**	**$ 12,284,834**
NET ASSETS				
Held in trust for pension benefits, pool participants, and other purposes	**$ 2,100,704**	**$ 362,864,065**	**$ 16,391,885**	

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, 2006
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment
ADDITIONS			
Contributions:			
Employer	$ —	$ 9,502,650	$ —
Plan member	—	5,915,274	—
Total contributions	—	**15,417,924**	—
Investment income:			
Net appreciation in fair value of investments	—	16,697,980	—
Interest, dividends, and other investment income	55,300	26,985,772	639,001
Less: investment expense	—	(4,983,917)	—
Net investment income	55,300	38,699,835	639,001
Receipts from depositors	383,956	—	21,685,379
Other	77,770	14,740	—
Total additions	**517,026**	**54,132,499**	**22,324,380**
DEDUCTIONS			
Distributions paid and payable to participants	—	16,087,540	637,443
Refunds of contributions	—	277,760	—
Administrative expense	9,366	343,247	1,559
Payments to and for depositors	130,351	392,730	23,865,306
Transfers out	105	—	—
Other	—	14,252	—
Total deductions	**139,822**	**17,115,529**	**24,504,308**
Change in net assets	377,204	37,016,970	(2,179,928)
Net assets, July 1, 2005	**1,723,500**	**325,847,095** *	**18,571,813**
Net assets, June 30, 2006	**$ 2,100,704**	**$ 362,864,065**	**$ 16,391,885**

* Restated

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

Discretely Presented Component Units Financial Statements

Statement of Net Assets

Discretely Presented Component Units – Enterprise Activity

June 30, 2006
(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	$ 328,050	$ 281,390	$ 765,172	$ 508,838	$ 618,153	$ 2,501,603
Investments	6,836,330	3,816,760	1,950,267	68,995	278,071	12,950,423
Restricted assets:						
Cash and pooled investments	—	—	—	—	11,902	11,902
Investments	—	—	—	—	52,943	52,943
Receivables (net)	1,591,603	1,504,918	396,119	1,779	308,849	3,803,268
Due from primary government	162,585	—	—	5,794	1,123	169,502
Due from other governments	448,298	—	—	130,290	72,479	651,067
Prepaid items	—	2,588	639	—	3,856	7,083
Inventories	129,210	—	—	—	293	129,503
Other current assets	127,227	250	104	—	50,228	177,809
Total current assets	9,623,303	5,605,906	3,112,301	715,696	1,397,897	20,455,103
Noncurrent assets:						
Restricted assets:						
Cash and pooled investments	—	—	—	—	115,502	115,502
Investments	—	—	—	—	87,508	87,508
Investments	14,267,344	16,154,930	41,391	1,821,602	931,017	33,216,284
Receivables (net)	677,866	—	—	—	203,961	881,827
Loans receivable	—	—	5,954,047	—	263,109	6,217,156
Deferred charges	—	25,159	31,398	—	1,716	58,273
Capital assets:						
Land	549,225	25,673	—	—	92,006	666,904
Collections – nondepreciable	254,550	—	—	—	3,828	258,378
Buildings and other depreciable property	23,663,203	419,031	1,522	—	1,506,610	25,590,366
Less: accumulated depreciation	(10,978,410)	(181,480)	(628)	—	(590,928)	(11,751,446)
Construction in progress	3,176,433	—	—	—	58,413	3,234,846
Other noncurrent assets	246,473	1,217,383	12,570	—	87,066	1,563,492
Total noncurrent assets	31,856,684	17,660,696	6,040,300	1,821,602	2,759,808	60,139,090
Total assets	**$ 41,479,987**	**$ 23,266,602**	**$ 9,152,601**	**$ 2,537,298**	**$ 4,157,705**	$ 80,594,193

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	$ 1,466,890	$ 55,801	$ 65,045	$ 270,773	$ 100,887	$ 1,959,396
Due to other governments	—	—	724	—	694	1,418
Deposits	323,815	—	163,786	—	1,457	489,058
Dividends payable	—	3,100	—	—	—	3,100
Deferred revenue	680,273	—	—	—	57,465	737,738
Contracts and notes payable	—	—	—	—	10,419	10,419
Advance collections	—	228,264	—	—	873	229,137
Interest payable	—	—	125,216	—	1,640	126,856
Benefits payable	—	3,662,040	—	—	—	3,662,040
Securities lending obligations	3,736,260	1,282,378	—	—	—	5,018,638
Current portion of long-term obligations	1,164,573	—	857,577	231,406	147,629	2,401,185
Other current liabilities	1,000,445	133,595	686	35,578	187,703	1,358,007
Total current liabilities	8,372,256	5,365,178	1,213,034	537,757	508,767	15,996,992
Noncurrent liabilities:						
Benefits payable	—	13,922,171	—	2,434,715	—	16,356,886
Compensated absences payable	209,398	57,740	—	—	9,777	276,915
Loans payable	—	—	—	—	9,078	9,078
Certificates of participation, commercial paper, and other borrowings	145,303	—	—	—	8,114	153,417
Capital lease obligations	1,901,274	—	—	—	208,910	2,110,184
Revenue bonds payable	5,871,783	—	6,588,622	—	548,854	13,009,259
Other noncurrent liabilities	905,081	378,004	82,738	—	303,021	1,668,844
Total noncurrent liabilities	9,032,839	14,357,915	6,671,360	2,434,715	1,087,754	33,584,583
Total liabilities	**17,405,095**	**19,723,093**	**7,884,394**	**2,972,472**	**1,596,521**	49,581,575
NET ASSETS						
Investment in capital assets, net of related debt	8,535,316	263,224	894	—	404,522	9,203,956
Restricted:						
Nonexpendable	2,399,592	—	—	—	580,703	2,980,295
Expendable:						
Endowments and gifts	6,374,078	—	—	—	7,245	6,381,323
Education	813,717	—	—	—	624,459	1,438,176
Indenture	—	—	703,539	—	—	703,539
Employee benefits	—	—	—	336,324	—	336,324
Workers' compensation liability	—	3,280,285	—	—	—	3,280,285
Statute	—	—	563,774	—	241,860	805,634
Other purposes	—	—	—	—	270,025	270,025
Total expendable	7,187,795	3,280,285	1,267,313	336,324	1,143,589	13,215,306
Unrestricted	5,952,189	—	—	(771,498)	432,370	5,613,061
Total net assets	**24,074,892**	**3,543,509**	**1,268,207**	**(435,174)**	**2,561,184**	31,012,618
Total liabilities and net assets	**$ 41,479,987**	**$ 23,266,602**	**$ 9,152,601**	**$ 2,537,298**	**$ 4,157,705**	$ 80,594,193

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

Statement of Activities

Discretely Presented Component Units – Enterprise Activity

Year Ended June 30, 2006
(amounts in thousands)

	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Public Employees' Benefits	Nonmajor Component Units	Total
OPERATING EXPENSES						
Personal services	9,488,014	710,648	20,016	—	508,860	10,727,538
Scholarships and fellowships	357,965	—	—	—	34,103	392,068
Supplies	1,826,954	—	—	—	6,014	1,832,968
Services and charges	349,788	63,600	63,851	3,164,569	1,136,311	4,778,119
Department of Energy laboratories	4,197,685	—	—	—	—	4,197,685
Depreciation	997,023	18,349	216	—	72,789	1,088,377
Distributions to beneficiaries	—	4,530,384	—	—	—	4,530,384
Interest expense and fiscal charges	347,172	—	344,711	—	36,025	727,908
Amortization of deferred charges	—	551,760	10,005	—	74	561,839
Grants provided	416,248	—	73,987	—	51,000	541,235
Other	2,312,389	148,615	—	—	77,793	2,538,797
Total operating expenses	**20,293,238**	**6,023,356**	**512,786**	**3,164,569**	**1,922,969**	31,916,918
PROGRAM REVENUES						
Charges for services	12,116,518	5,946,401	10,970	3,102,717	1,088,497	22,265,103
Operating grants and contributions	7,067,721	—	115,745	—	523,518	7,706,984
Capital grants and contributions	166,502	—	—	—	8,309	174,811
Total program revenues	**19,350,741**	**5,946,401**	**126,715**	**3,102,717**	**1,620,324**	30,146,898
Net (expense) revenue	(942,497)	(76,955)	(386,071)	(61,852)	(302,645)	(1,770,020)
GENERAL REVENUES						
Investment and interest income	1,065,284	403,530	449,312	144,920	132,165	2,195,211
Other	1,724,546	111,926	15,566	382	295,346	2,147,766
Total general revenues	**2,789,830**	**515,456**	**464,878**	**145,302**	**427,511**	4,342,977
Change in net assets	1,847,333	438,501	78,807	83,450	124,866	2,572,957
Net assets, July 1, 2005	**22,227,559**	**3,105,008**	**1,189,400**	**(518,624)**	**2,436,318 ***	28,439,661
Net assets, June 30, 2006	**$ 24,074,892**	**$ 3,543,509**	**$ 1,268,207**	**$ (435,174)**	**$ 2,561,184**	$ 31,012,618

* 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) Statements have been implemented for the year ended June 30, 2006:

GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries;*

GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section;*

GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation;* and

GASB Statement No. 47, *Accounting for Termination Benefits.*

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 component 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 $606 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 94814.

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 $198 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 two 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.

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. The University of California offers defined benefit pension plans and defined contribution pension plans to its employees through the University of California Retirement System (UCRS). The UCRS is a discretely presented fiduciary component unit of the university; and as such, the financial information of the UCRS is not included in the financial statements of this report. Copies of the University of California's and the UCRS' 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, 2005, 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 because 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, because the primary government can impose its will on the entity, or because 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 EdFund financial report included in this entity is as of and for the year ended September 30, 2005);

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, 2005);

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, 2006, CADA had total assets of $27.0 million, total liabilities of $19.0 million, and total net assets of $8.2 million. Total revenues for the fiscal year were $8.5 million and expenses were $8.2 million, resulting in a net income of $291,038. 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 provides 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 appointees of the Governor, 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 separate 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 initial oversight board 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 mobile home 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 (BATA)*, 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. In 2005, the California State Legislature transferred toll-bridge administration responsibility from the California Department of Transportation (Caltrans) to BATA. This responsibility includes consolidation of all the toll-bridge revenue, including the one-dollar per vehicle seismic surcharge for the seven bridges, under BATA's administration. The State's seismic dollar was formerly administered by Caltrans to be used to complete the Toll Bridges Seismic Retrofit Program. The State issued Bay Area Toll Bridges Seismic Retrofit Revenue Bonds that were backed by the revenue generated by the seismic dollar. In April 2006, BATA issued bonds to defease the State's bonds as further described in Note 16, Revenue Bonds. BATA is a blended component unit of the Metropolitan Transportation Commission. Additional information 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) give 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 the cost of centralized services provided to federal programs from the federal government.

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 State maintains the minimum number of funds 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. In this report, 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. In this report, 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 they are 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. The State records revenue sources when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months. 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.

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. **Agency funds** are custodial in nature and do not measure the results of operations.

The accounts of the proprietary fund types, the investment trust fund, private purpose trust funds, pension and other employee benefit trust funds, and agency 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 they are 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 expenditures 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 include 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 recoded 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 49,560 lane-miles and 12,120 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 the compensated absences for employees that have left state service and have unused reimbursable leave at year-end would be included. 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 in the same manner 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. As of June 30, 2006, the government-wide financial statements show restricted net assets for the primary government of $17.2 billion, of which $9.1 billion is due to enabling legislation.

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 appropriations 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.

Reserved for debt service represents the amount legally reserved for the payment of bonded indebtedness that is not available for other purposes until the bonded indebtedness is liquidated.

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 **governmental funds** decreased by a net total of $3 million. This decrease is comprised of an increase of $18 million in the Transportation Construction Fund—a result of prior-period adjustments to correct errors—and a decrease of $21 million in the **nonmajor governmental funds** as a result of prior-period adjustments to correct errors and the reclassification of funds.

The beginning fund balance of the **nonmajor enterprise funds** increased by a net total of $67 million as a result of prior-period adjustments to correct errors and the reclassification of funds.

The beginning net assets of the **fiduciary funds** decreased by a total of $53.2 billion as a result of previously including the University of California Retirement System as a fiduciary activity of the State, when in fact it is a fiduciary activity of the University of California, a discretely presented component unit of the State.

Beginning net assets of the **discretely presented component units – enterprise activity** increased by a total of $28 million. Most of this increase was the result of reporting the EDFUND as an additional nonmajor discretely presented component unit The remaining increase is a result of prior-period adjustments to correct errors.

2. Government-wide Financial Statements

The beginning net assets of the **governmental activities**, the **business-type activities**, and the **component units** were restated as described in the previous section for governmental funds, nonmajor enterprise 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 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, 2006, were legally made, and they had the effect of increasing 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 in which 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 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.

As required by generally accepted accounting principles, certain risk disclosures are included in this note to the extent that the risks exist at the date of the statement of net assets. Disclosure of the following risks are included:

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

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 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 invest 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, 2006, the discretely presented component units accounted for approximately 3.0% 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, 2006, totaling approximately $8.1 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, 2006, the State Treasurer's Office had amounts on deposit with a fiscal agent totaling $29 million related to principal and interest payments to bondholders. Additionally, $4 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, 2006, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 119 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 moneys 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, 2006, 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 $450 million in interest revenue received by the General Fund from the pooled investment program in the 2005-06 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, 2006, structured notes and asset-backed securities comprised slightly more than 2.5% 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 provided a hedge 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 fall 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, 2006
(amounts in thousands)

	Interest Rates*	Maturity	Fair Value at Year End	Weighted Average Maturity (in years)
Pooled investments				
U.S. Treasury bills and notes	2.65 - 5.26	27 days - 1.92 years	$ 3,263,578	0.65
U.S. agency bonds and discount notes	1.75 - 5.38	21 days - 1.21 years	16,969,636	0.42
Small Business Administration loans	5.05 - 5.88	.25 year	720,458	0.25 **
Mortgage-backed securities #	3.92 - 14.25	32 days - 9.13 years	638,355	2.84
Certificates of deposit	4.73 - 5.53	3 days - 180 days	13,634,447	0.20
Commercial paper	4.77 - 5.42	3 days - 151 days	11,841,253	0.10
Corporate bonds and notes	1.91 - 5.56	5 days - 2.33 years	2,035,956	0.37 ***
Total pooled investments			**49,103,683** @	
Other primary government investments				
U.S. Treasuries and agencies			2,243,357	4.75 ****
Commercial paper			517,353	N/A *****
Guaranteed investment contracts			697,578	15.82
Corporate debt securities			246,059	1.74
Other			597,506	1.09
Total other primary government investments			**4,301,853**	
Funds outside primary government included in pooled investments				
Less: investment trust funds			16,505,617	
Less: other trust and agency funds			1,920,707	
Less: discretely presented component units			1,900,780	
Total primary government investments			**$ 33,078,432**	

* 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.

**** $33 million of U.S. Treasuries and agencies securities mature in less than one year.

***** These commercial paper holdings of the California State University and the Golden State Tobacco Securitization Corporation mature in less than one year.

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

@ Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include $7.9 billion of time deposits and $6.4 billion of loans to State funds, which are reported as cash in the respective funds.

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, 2006
(amounts in thousands)

Pooled investments	Fair Value at Year End	% of Total Pooled Investments
Mortgage-backed		
Federal National Mortgage Association Collateralized Mortgage Obligations	$ 636,914	1.297 %
Government National Mortgage Association Pools	266	0.001
Federal Home Loan Mortgage Corporation Participation Certificate Pools	1,175	0.002

These mortgage-backed securities 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 prepayments 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, 2006
(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	$ 37,918,361	**
A-1/P-1/F-1	AA/Aa/AA	4,970,095	
A-2/P-2/F-2	A/A/A	1,503,745	
—	BB***	89,090	
Not rated		638,090	
Not applicable		3,984,302	
Total pooled investments		**$ 49,103,683**	****
Other primary government investments			
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 1,016,708	
A-1/P-1/F-1	AA/Aa/AA	362,835	
A-2/P-2/F-2	A/A/A	234,900	
Not rated		603,600	
Not applicable		2,083,810	
Total other primary government investments		**$ 4,301,853**	

* The State 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 $10.9 billion in Freddie Mac issued discount notes. Freddie Mac has not requested that all of its debt be rated, but all debt that 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.

**** Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include time deposits of $7.9 billion, for which credit risk is mitigated by collateral that the State holds for them, as discussed earlier in this note, and loans to State funds of $6.4 billion, for which external credit risk is not applicable because they are internal loans.

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, 2006
(amounts in thousands)

POOLED INVESTMENTS

Issuer	Investment Type	Reported Amount	% of Total Pooled Investments
Federal Home Loan Mortgage Corp.	U.S. agency securities	$ 10,865,395	22.13 %
Federal Home Loan Bank	U.S. agency securities	5,959,446	12.14
General Electric Capital/GE Company	Corporate Bonds/Commercial Paper	2,679,434	5.46

OTHER PRIMARY GOVERNMENT INVESTMENTS

Issuer	Investment Type	Reported Amount	% of Total Agency Investments
Golden State Tobacco Securitization Corporation			
Coral	Commercial paper	$ 58,367	11.59 %
Briarwood	Commercial paper	63,554	12.62
Morgan Stanley	Commercial paper	139,344	27.67
Security Benefit Life Insurance	Commercial paper	65,014	12.91
Curzon	Commercial paper	64,661	12.84
Greyhawk	Commercial paper	75,438	14.98
Department of Veterans Affairs			
Bayerische Landesbank	Guaranteed investment contracts	$ 46,053	30.45 %
Societe Generale	Guaranteed investment contracts	40,003	26.45
Westdeutsche Landesbank	Guaranteed investment contracts	58,861	38.92

4. Custodial Credit Risk

The State of California has a deposit policy for custodial credit risk that requires deposits held by financial institutions to be insured by federal depository insurance or secured by collateral. As of June 30, 2006, $23 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 fund for the California Scholarshare program, and various other funds. CalPERS and CalSTRS 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 negative $248 million as of June 30, 2006. 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, 2006, CalPERS had an approximately negative $248 million net exposure to loss from forward foreign currency exchange transactions related to the approximately $51.0 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 that CalSTRS enters into under a limited partnership agreement. For alternative investments and other investments for which 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 that CalPERS has minimized its credit risk exposure by requiring the borrowers to provide collateral greater than 100% of the market value of the securities loaned. The securities loaned 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 two externally managed portfolios and one internally managed portfolio were 413 days, 108 days, and 497 days. In accordance with CalPERS' investment guidelines, the cash collateral was invested in short-term investment funds that, at June 30, 2006, had durations of 43 days, 11 days, and 32 days, for two externally managed portfolios and one internally managed portfolio.

For CalSTRS, collateral received on each security loan was placed in investments that, at June 30, 2006, had a 22-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, 2006, 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.

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

Table 6

Schedule of Investments - Fiduciary Funds
June 30, 2006
(amounts in thousands)

Investment Type	Fair Value
Equity securities	$ 221,799,577
Debt securities*	88,532,320
Investment contracts	724,980
Mutual funds	6,138,831
Real estate	27,044,181
Insurance contracts	400,742
Private equity	20,654,660
Securities lending collateral	65,637,546
Other	1,053,977
Total investments	**$ 431,986,814**

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

1. Interest Rate Risk

CalPERS and CalSTRS 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 in 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 fall within a 0-30 day range and/or be invested in U.S. government and agency obligations.

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

Table 7

Schedule of Investments in Fixed-Income Securities - Fiduciary Funds - Interest Rate Risk
June 30, 2006
(amounts in thousands)

	Fair Value at Year End	Effective Duration**
California Public Employees' Retirement Fund *		
U.S. Treasuries and agencies	$ 13,612,123	9.25
Mortgages	17,213,403	4.69
Corporate	14,478,104	8.52
Asset-backed	1,424,437	3.43
International	5,634,777	6.61
Not rated ***	702,405	N/A
Total	**$ 53,065,249**	
Deferred Compensation Plan Fund		
Investment contracts	$ 724,980	5.34
Scholarshare Program Trust Fund		
Insurance contracts	$ 400,742	3.10
California State Teachers' Retirement System		
Long-term fixed-income investments		
U.S. Government and agency obligations	$ 8,414,312	4.51
Corporate	7,950,240	5.61
High yield	1,451,592	3.89
Asset-backed securities	835,240	2.69
Commercial mortgage-backed securities	1,707,614	4.59
Mortgage-backed securities	11,405,515	4.61
Total	**$ 31,764,513**	

	0-30 days	31-90 days	91-120 days
Short-term fixed-income investments			
Money market securities	$ 340,782	$ 209,117	$ —
Corporate bonds	—	—	—
Corporate floating-rate notes	48,609	113,079	7,001
U.S. Government and agency obligations			
Noncallables	35,000	—	—
Discount notes	309,536	218,167	—
Callable	63,000	55,997	39,000
U.S. Treasury	—	—	—
Asset-backed securities	12,810	15,600	—
Total	**$ 809,737**	**$ 611,960**	**$ 46,001**

* Includes investments of fiduciary funds and certain discretely presented component units that CalPERS administers.
** Effective duration is described in the paragraph preceding this table.
*** Securities held in externally managed investment pools or in default.

121-180 days	181-365 days	365+ days	Fair Value at Year End
$ —	$ —	$ —	$ 549,899
—	—	14,984	14,984
—	—	—	168,689
29,937	25,000	—	89,937
—	—	—	527,703
5,000	—	—	162,997
—	112,084	—	112,084
—	—	—	28,410
$ 34,937	**$ 137,084**	**$ 14,984**	**$ 1,654,703**

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 Poor's 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 that are managed externally and allow for the purchase of bonds rated below investment grade. Limitations on the amount of debt of any one issuer a manager may hold are negotiated on a manager-by-manager basis.

Table 8 presents the credit risk of the fixed-income securities of these fiduciary funds.

Table 8

Schedule of Investments in Fixed-Income Securities – Fiduciary Funds – Credit Risk
June 30, 2006
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 56,339,186
A-1/P-1/F-1	AA/Aa/AA	19,036,655
A-2/P-2/F-2	A/A/A	12,870,052
A-3/P-3/F-3	BBB/Baa/BBB	10,989,877
B/NP/B	BB/Ba/BB	1,672,477
B/NP/B	B/B/B	2,699,901
C/NP/C	CCC/Caa/CCC	125,188
C/NP/C	CC/Ca/CC	65,231
Not rated		2,267,273
Total fixed-income securities		**$ 106,065,840**

3. Concentration of Credit Risk

The Deferred Compensation Plan Fund held $725 million in investment contracts of Dwight Asset Management Company, which represented 11.9% of the fund's total investments as of June 30, 2006. The Scholarshare Program Trust Fund held $401 million in insurance contracts of TIAA-CREF Life Insurance Company, which represented 19.1% of the fund's total investments as of June 20, 2006.

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 and CalSTRS have policies or practices to minimize custodial risk, and their investments at June 30, 2006, were not exposed to custodial risk.

5. Foreign Currency Risk

At June 30, 2006, CalPERS and CalSTRS held $52.0 billion and $30.8 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 33% 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 approximately 25% of the total international equity portfolio. Its currency exposures are monitored daily. CalSTRS believes that its currency-management program should emphasize 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.

Table 9 identifies the investments of these fiduciary funds that are subject to foreign currency risk.

Table 9

Schedule of Investments - Fiduciary Funds - Foreign Currency Risk
June 30, 2006
(amounts in thousands of U.S. dollars at fair value)

Currency	Cash	Equity	Alternative	Fixed Income	Real Estate	Currency Overlay	Total
Argentine Peso	$ 14	$ —	$ —	$ —	$ —	$ —	$ 14
Australian Dollar	58,903	3,231,090	16,609	130,886	11,966	(3,960)	3,445,494
Brazilian Real	6,550	765,410	—	—	—	386	772,346
British Pound Sterling	145,573	14,020,722	584,942	1,005,766	—	(50,105)	15,706,898
Canadian Dollar	43,201	3,461,961	48,692	564,352	64,916	(20,366)	4,162,756
Chilean Peso	1,165	56,888	—	—	—	—	58,053
Chinese Yuan	—	2,436	—	—	—	—	2,436
Czech Koruna	656	34,975	—	—	—	—	35,631
Danish Krone	7,384	366,834	650	258,790	—	2,299	635,957
Egyptian Pound	—	11,825	—	—	—	—	11,825
Euro	337,216	23,472,041	646,231	2,157,027	—	203,310	26,815,825
Hong Kong Dollar	16,863	1,880,896	—	—	28,560	1,204	1,927,523
Hungarian Forint	1,038	226,491	—	37,767	—	—	265,296
Indian Rupee	866	334,511	—	—	—	—	335,377
Indonesian Rupiah	1,127	148,600	—	—	—	62	149,789
Israeli Shekel	17	225,189	—	—	—	(905)	224,301
Japanese Yen	166,569	14,547,853	16,753	882,210	48,563	55,576	15,717,524
Malaysian Ringgit	547	256,988	—	—	—	(81)	257,454
Mexican Peso	5,984	502,283	—	103,665	—	(2,380)	609,552
Moroccan Dirham	630	13,067	—	—	—	—	13,697
New Zealand Dollar	2,135	78,103	—	—	—	—	80,238
Norwegian Krone	5,929	609,295	—	132,545	—	(1,080)	746,689
Philippine Peso	3,163	79,451	—	—	—	—	82,614
Polish Zloty	240	113,037	—	92,588	—	(116)	205,749
Singapore Dollar	18,463	583,960	—	117,832	20,454	69	740,778
South African Rand	3,113	961,985	—	8,236	—	1,667	975,001
South Korean Won	2,779	1,756,280	—	32,396	—	—	1,791,455
Sri Lanka Rupee	—	359	—	—	—	—	359
Swedish Krona	26,648	1,412,285	—	6,044	—	1,308	1,446,285
Swiss Franc	16,991	4,216,492	318	—	—	26,074	4,259,875
Taiwan Dollar	12,850	1,213,070	—	—	—	—	1,225,920
Thailand Baht	462	193,042	—	—	—	—	193,504
Turkish New Lira	2,832	338,978	—	—	—	310	342,120
Total exposure to foreign currency risk	**$ 889,908**	**$ 75,116,397**	**$ 1,314,195**	**$ 5,530,104**	**$ 174,459**	**$ 213,272**	**$ 83,238,335**

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 Agency (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, 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, as well as 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 have placed constraints on allowable investments, assets associated with endowments are invested in accordance with the terms of the agreements.

The University of California participates in a securities lending program as a means to augment income. Campus foundations' cash, 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 the foundations' 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 that equals or exceeds 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, 2006, 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, 2006, the securities in these pools had a weighted average maturity of 34 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, 2005, with maturities matching the related loans. Interest income on these investments is shared by the borrower, the third-party lending agent, and SCIF.

Table 10 presents the investments of the discretely presented component units by investment type.

Table 10

Schedule of Investments – Discretely Presented Component Units
June 30, 2006
(amounts in thousands)

Investment Type	Fair Value
Equity securities	$ 4,992,145
Debt securities*	29,334,179
Investment contracts	1,959,535
Mutual funds	3,405,322
Real estate	302,398
Money market securities	389,600
Private equity	381,187
Mortgage loans	253,493
Externally held irrevocable trusts	275,887
Securities lending collateral	5,021,384
Invested for others	(1,133,659)
Other	1,125,687
Total investments	**$ 46,307,158**

* 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 (Lehman Aggregate Index), 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 11 presents the interest rate risk of the fixed-income securities of the major discretely presented component units.

Table 11

Schedule of Investments in Fixed-Income Securities - Discretely Presented Component Units - Interest Rate Risk
June 30, 2006
(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	$ 1,497,513	2.50	$ 83,863	3.20
U.S. Treasury strips	41,791	10.80	—	—
U.S. TIPS	243,672	5.10	—	—
U.S. government-backed securities	3,764	6.60	5,560	3.90
U.S. government-backed asset-backed securities	3,098	5.10	21	3.20
Corporate bonds	1,869,577	2.40	58,191	5.10
Commercial paper	2,685,766	0.00	—	—
U.S. agencies	1,698,310	1.10	88,660	2.80
U.S. agencies asset-backed securities	313,912	4.60	2,089	3.60
Corporate asset-backed securities	123,151	8.40	2,452	1.30
Supranational/foreign	789,424	2.00	618	1.80
Other	536	8.80	1,211	2.00
Corporate (foreign currency denominated)	6,437	27.10	—	—
U.S. bond funds	34,800	4.80	195,062	5.00
Non-U.S. bond funds	—	—	9,306	5.90
Money market funds	10,127	0.00	372,968	1.10
Mortgage loans	246,741	0.00	6,752	0.00
Total	**$ 9,568,619**		**$ 826,753**	

Investment Type	State Compensation Insurance Fund		California Housing Finance Agency	
	Fair Value at Year End	Weighted Average Maturity	Fair Value at Year End	Effective Duration
Securities lending collateral	$ 1,285,600	0.08	$ —	—
U.S. Treasury and agency securities	5,333,022	2.72	47,940	7.00
Municipal securities	242,314	10.92	—	—
Public utilities	572,792	5.80	—	—
Corporate bonds	5,434,676	4.59	—	—
Commercial paper	234,269	0.08	77,560	0.03
Special revenue	756,456	9.89	—	—
Other government	297,338	2.02	—	—
Mortgage-backed securities	5,491,348	21.26	—	—
Mutual funds	323,875	0.08	—	—
Total	**$ 19,971,690**		**$ 125,500**	

Table 12 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 12

Schedule of Highly Sensitive Investments in Debt Securities – University of California and its Foundations – Interest Rate Risk
June 30, 2006
(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-Backed 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.	$ 372,010	6.10	$ 72,678	2.80
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 underlying mortgages are subject to a lower propensity of prepayments.	68,151	3.50	13,618	2.30
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.			2,409	1.30
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.	736,511	1.50	1,095	4.20

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 Lehman Aggregate Index, which is comprised of approximately 30% high grade corporate bonds and 30% to 35% mortgage/asset-backed securities, all of which carry some degree of credit risk. The remaining 35% to 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 ratings 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 13 presents the credit risk of the fixed-income securities of the major discretely presented component units.

Table 13

Schedule of Investments in Fixed-Income Securities – Major Discretely Presented Component Units – Credit Risk
June 30, 2006
(amounts in thousands)

Credit Rating as of Year End		
Short-term	**Long-term**	**Fair Value**
A-1+/P-1/F-1+	AAA/Aaa/AAA	$ 16,535,596
A-1/P-1/F-1	AA/Aa/AA	6,236,567
A-2/P-2/F-2	A/A/A	5,865,920
A-3/P-3/F-3	BBB/Baa/BBB	731,868
B/NP/B	BB/Ba/BB	97,031
B/NP/B	B/B/B	7,074
Not rated		957,443
Total fixed-income securities		**$ 30,431,499**

3. Concentration of Credit Risk

Investment guidelines addressing concentration of credit risk related to the investment-grade 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 $1.2 billion in Federal agency securities of the Federal National Mortgage Association and $805 million in Federal agency securities of the Federal Home Loan Mortgage Corporation, which represented 8.70% and 6.09%, respectively, of the university's total investments as of June 30, 2006.

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 of certain 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 14 presents the fixed-income securities of the major discretely presented component units subject to custodial credit risk.

Table 14

Schedule of Investments in Fixed-Income Securities – University of California Foundations – Custodial Credit Risk
June 30, 2006
(amounts in thousands)

	Fair Value
Investment Type	
Domestic equity securities	$ 200,454
Foreign equity securities	16,286
U.S. Treasury bills, notes, and bonds	42,123
U.S. government-backed securities	1,782
Corporate bonds	11,247
U.S. agencies	18,017
Corporate asset-backed securities	467
Total exposure to custodial credit risk	**$ 290,376**

5. Foreign Currency Risk

The University of California's portfolio guidelines for U.S. investment-grade 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 15 identifies the investments of the University of California – including its campus foundations – that are subject to foreign currency risk.

Table 15

Schedule of Investments – University of California – Foreign Currency Risk

June 30, 2006

(amounts in thousands of U.S. dollars at fair value)

Currency	Equity	Fixed-Income	Total
Australian Dollar	$ 52,560	$ —	$ 52,560
British Pound Sterling	289,683	—	289,683
Canadian Dollar	63,992	6,437	70,429
Danish Krone	7,300	—	7,300
Euro	398,171	—	398,171
Hong Kong Dollar	32,202	—	32,202
Japanese Yen	271,837	—	271,837
New Zealand Dollar	1,266	—	1,266
Norwegian Krone	9,215	—	9,215
Singapore Dollar	13,250	—	13,250
South African Rand	2,428	—	2,428
South Korean Won	5,183	—	5,183
Swedish Krona	20,920	—	20,920
Swiss Franc	91,203	—	91,203
Thailand Baht	1,431	—	1,431
Other	13,780	—	13,780
Commingled currencies	870,991	—	870,991
Total exposure to foreign currency risk	**$ 2,145,412**	**$ 6,437**	**$ 2,151,849**

NOTE 4: ACCOUNTS RECEIVABLE

Table 16 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 16

Schedule of Accounts Receivable
June 30, 2006
(amounts in thousands)

	Taxes	Reimbursement of Accrued Interest Expense	Lottery Retailers	Unemployment Programs	Other	Total
Current governmental activities						
General Fund	$ 7,398,343	$ —	$ —	$ —	$ 687,861	$ 8,086,204
Federal Fund	—	—	—	—	76,666	76,666
Transportation Construction Fund	324,672	—	—	—	71,693	396,365
Nonmajor governmental funds	191,811	63	—	—	1,143,926	1,335,800
Internal service funds	—	—	—	—	149,458	149,458
Adjustment:						
Fiduciary funds	—	—	—	—	132,485	132,485
Total current governmental activities	**$ 7,914,826**	**$ 63**	**$ —**	**$ —**	**$ 2,262,089**	**$ 10,176,978**
Amounts not scheduled for collection during the subsequent year	**$ 1,128,241**	**$ —**	**$ —**	**$ —**	**$ 81,156**	**$ 1,209,397**
Current business-type activities						
Water Resources Fund	—	—	—	—	109,952	109,952
Public Buildings Construction Fund	—	126,480	—	—	—	126,480
State Lottery Fund	—	—	228,844	—	—	228,844
Unemployment Programs Fund	—	—	—	156,814	—	156,814
Nonmajor enterprise funds	—	—	—	—	44,188	44,188
Adjustment:						
Account reclassification	—	(126,480)	—	—	(3,239)	(129,719)
Total current business-type activities	**$ —**	**$ —**	**$ 228,844**	**$ 156,814**	**$ 150,901**	**$ 536,559**
Amounts not scheduled for collection during the subsequent year	**$ —**	**$ —**	**$ —**	**$ 30,503**	**$ —**	**$ 30,503**

NOTE 5: RESTRICTED ASSETS

Table 17 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 17

Schedule of Restricted Assets
June 30, 2006
(amounts in thousands)

	Cash and Pooled Investments	Investments	Due From Other Governments	Loans Receivable	Total
Primary government					
Debt service	$ 1,384,174	$ 683,066	$ 58,300	$ 569,003	$ 2,694,543
Construction	94,144	—	—	—	94,144
Operations	1,541,002	—	—	—	1,541,002
Other	15,537	—	—	—	15,537
Total primary government	**3,034,857**	**683,066**	**58,300**	**569,003**	**4,345,226**
Discretely presented component units					
Nonmajor component units – debt service	127,404	140,451	—	—	267,855
Total discretely presented component units	**127,404**	**140,451**	**—**	**—**	**267,855**
Total restricted assets	**$ 3,162,261**	**$ 823,517**	**$ 58,300**	**$ 569,003**	**$ 4,613,081**

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

Table 18

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
2007	$ 465,198	$ 160,109	$ 64,669	$ 689,976
2008	463,131	163,854	64,905	691,890
2009	456,499	161,838	64,627	682,964
2010	440,275	154,441	63,846	658,562
2011	417,562	154,305	62,516	634,383
2012-2016	1,981,448	723,019	277,250	2,981,717
2017-2021	1,550,066	580,091	93,978	2,224,135
2022-2026	826,354	333,838	32,792	1,192,984
2027-2031	377,399	196,727	26,168	600,294
Total minimum lease payments	**6,977,932**	**2,628,222**	**750,751**	**10,356,905**
Less: unearned income	2,678,674	992,505	224,843	3,896,022
Net investment in direct financing leases	**$ 4,299,258**	**$ 1,635,717**	**$ 525,908**	**$ 6,460,883**

NOTE 7: CAPITAL ASSETS

Table 19 summarizes the capital activity for the primary government, which includes $5.8 billion in capital assets related to capital leases.

Table 19

Schedule of Changes in Capital Assets – Primary Government
June 30, 2006
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Governmental activities				
Capital assets not being depreciated				
Land	$ 14,730,050	$ 610,571	$ 190,261	$ 15,150,360
State highway infrastructure	55,114,882	710,636	100,027	55,725,491
Collections	19,354	1,065	2	20,417
Construction in progress	5,628,463	2,868,995	2,014,304	6,483,154
Total capital assets not being depreciated	**75,492,749**	**4,191,267**	**2,304,594**	**77,379,422**
Capital assets being depreciated				
Buildings and improvements	15,290,043	1,305,565	265,849	16,329,759
Infrastructure	409,703	116,035	3,239	522,499
Equipment and other assets	3,988,170	307,501	357,995	3,937,676
Total capital assets being depreciated	**19,687,916**	**1,729,101**	**627,083**	**20,789,934**
Less accumulated depreciation for:				
Buildings and improvements	4,826,144	588,122	90,880	5,323,386
Infrastructure	127,375	27,487	6,109	148,753
Equipment and other assets	3,048,796	295,349	410,008	2,934,137
Total accumulated depreciation	**8,002,315**	**910,958**	**506,997**	**8,406,276**
Total capital assets being depreciated, net	**11,685,601**	**818,143**	**120,086**	**12,383,658**
Governmental activities, capital assets, net	**$ 87,178,350**	**$ 5,009,410**	**$ 2,424,680**	**$ 89,763,080**
Business-type activities				
Capital assets not being depreciated				
Land	$ 45,782	$ 2	$ —	$ 45,784
Construction in progress	1,612,665	391,251	1,101,291	902,625
Total capital assets not being depreciated	**1,658,447**	**391,253**	**1,101,291**	**948,409**
Capital assets being depreciated				
Buildings and improvements	6,708,231	369,270	60,758	7,016,743
Infrastructure	1,208,258	11,799	10	1,220,047
Equipment and other assets	81,908	11,911	3,576	90,243
Total capital assets being depreciated	**7,998,397**	**392,980**	**64,344**	**8,327,033**
Less accumulated depreciation for:				
Buildings and improvements	2,515,468	180,527	25,476	2,670,519
Infrastructure	677,051	19,676	—	696,727
Equipment and other assets	53,838	9,735	4,352	59,221
Total accumulated depreciation	**3,246,357**	**209,938**	**29,828**	**3,426,467**
Total capital assets being depreciated, net	**4,752,040**	**183,042**	**34,516**	**4,900,566**
Business-type activities, capital assets, net	**$ 6,410,487**	**$ 574,295**	**$ 1,135,807**	**$ 5,848,975**

Table 20 summarizes the depreciation expense charged to the activities of the primary government.

Table 20

Schedule of Depreciation Expense – Primary Government
June 30, 2006
(amounts in thousands)

	Amount
Governmental activities	
General government	$ 70,795
Education	305,690
Health and human services	38,624
Resources	58,943
State and consumer services	37,657
Business and transportation	87,828
Correctional programs	229,403
Internal service funds (charged to the activities that utilize the fund)	82,018
Total depreciation expense – governmental activities	**910,958**
Business-type activities	
Enterprise	**209,938**
Total primary government	**$ 1,120,896**

Table 21 summarizes the capital activity for discretely presented component units.

Table 21

Schedule of Changes in Capital Assets – Discretely Presented Component Units
June 30, 2006
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Capital assets not being depreciated				
Land	$ 598,297	$ 72,023	$ 3,416	$ 666,904
Collections	250,445	9,351	1,418	258,378
Construction in progress	3,359,432	51,015	175,601	3,234,846
Total capital assets not being depreciated	**4,208,174**	**132,389**	**180,435**	**4,160,128**
Capital assets being depreciated				
Buildings and improvements	15,622,634	1,731,787	1,792	17,352,629
Equipment and other depreciable assets	7,548,727 *	584,872	294,343	7,839,256
Infrastructure	366,133	37,257	4,909	398,481
Total capital assets being depreciated	**23,537,494 ***	**2,353,916**	**301,044**	**25,590,366**
Less accumulated depreciation for:				
Buildings and improvements	5,805,752	544,529	8,284	6,341,997
Equipment and other depreciable assets	4,977,918 *	537,094	276,729	5,238,283
Infrastructure	164,527	6,754	115	171,166
Total accumulated depreciation	**10,948,197 ***	**1,088,377**	**285,128**	**11,751,446**
Total capital assets being depreciated, net	**12,589,297 ***	**1,265,539**	**15,916**	**13,838,920**
Capital assets, net	**$ 16,797,471 ***	**$ 1,397,928**	**$ 196,351**	**$ 17,999,048**

* Restated

NOTE 8: ACCOUNTS PAYABLE

Accounts payable are amounts due to taxpayers, vendors, customers, beneficiaries, and employees related to different programs. Table 22 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 22

Schedule of Accounts Payable
June 30, 2006
(amounts in thousands)

	Education	Health and Human Services	Resources	Business and Transportation	General Government and Others	Total
Governmental activities						
General Fund	$ 660,084	$ 211,630	$ 112,425	$ 1,191	$ 554,443	$ 1,539,773
Federal Fund	588,476	344,737	63,600	272,895	276,567	1,546,275
Transportation Construction Fund	1,007	—	—	121,687	2,006	124,700
Nonmajor governmental funds	558,690	566,876	178,061	1,145,466	554,185	3,003,278
Internal service funds	—	—	6,157	4,449	151,121	161,727
Adjustment:						
Fiduciary funds	4,003,763	3,553,931	—	43,431	600,419	8,201,544
Total governmental activities	**$ 5,812,020**	**$ 4,677,174**	**$ 360,243**	**$ 1,589,119**	**$ 2,138,741**	**$ 14,577,297**
Business-type activities						
Electric Power Fund	$ —	$ —	$ 394,000	$ —	$ —	$ 394,000
Water Resources Fund	—	—	69,733	—	—	69,733
Public Building Construction Fund	—	—	—	—	4,072	4,072
State Lottery Fund	—	—	—	—	35,782	35,782
Unemployment Program Fund	—	14	—	—	3	17
Nonmajor enterprise funds	18,244	402	48	1,865	1,575	22,134
Adjustment:						
Fiduciary funds	—	—	—	—	10,850	10,850
Total business-type activities	**$ 18,244**	**$ 416**	**$ 463,781**	**$ 1,865**	**$ 52,282**	**$ 536,588**

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 November 10, 2005, the State issued $3.0 billion of RANs to fund cash flow needs for the 2005-06 fiscal year. The RANs were repaid on June 30, 2006.

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, 2006, draws totaling $57 million were outstanding.

NOTE 10: LONG-TERM OBLIGATIONS

As of June 30, 2006, the primary government had long-term obligations totaling $101.7 billion. Of that amount, $6.2 billion is due within one year. The $6.2 billion includes $575 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 2006. The largest change in governmental activities long-term obligations is an increase of $2.8 billion in the Proposition 98 minimum funding guarantee owed to schools related to a settlement reached with the California Teacher's Association.

The other long-term obligations for governmental activities consist of $1.2 billion for net pension obligations, $385 million owed for lawsuits, and the University of California unfunded pension liability of $74 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 $566 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 23 summarizes the changes in the long-term obligations during the year ended June 30, 2006.

Table 23

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

	Balance July 1, 2005	Additions	Deductions	Balance June 30, 2006	Due Within One Year	Noncurrent Liabilities
Governmental activities						
Loans payable	$ 1,011,800	$ 42,874	$ —	$ 1,054,674	$ —	$ 1,054,674
Compensated absences payable	1,724,963	871,153	821,452	1,774,664	99,658	1,675,006
Certificates of participation and commercial paper	752,013	3,952,704	3,780,827	923,890	581,994	341,896
Capital lease obligations	3,918,560	757,098	208,830	4,466,828	201,628	4,265,200
General obligation bonds payable	45,541,417	5,517,040	4,054,640	47,003,817	1,792,430	45,211,387
Revenue bonds payable	8,068,980	3,381,388	4,149,730	7,300,638	99,995	7,200,643
Proposition 98 funding guarantee	1,417,600	2,847,000	17,000	4,247,600	133,000	4,114,600
Workers compensation	2,805,933	110,495	341,729	2,574,699	313,894	2,260,805
Mandated costs	2,323,377	726,299	204,108	2,845,568	1,204,020	1,641,548
Other long-term obligations	1,644,028	67,772	47,600	1,664,200	47,940	1,616,260
Total	**$ 69,208,671**	**$ 18,273,823**	**$ 13,625,916**	**$ 73,856,578**	**$ 4,474,559**	**$ 69,382,019**
Business-type activities						
Benefits payable	$ 16,591	$ —	$ 2,583	$ 14,008	$ —	$ 14,008
Lottery prizes and annuities	2,346,665	2,298,052	2,423,653	2,221,064	661,766	1,559,298
Compensated absences payable	44,829	22,640	18,354	49,115	24,323	24,792
Certificates of participation and commercial paper	51,093	257,496	77,468	231,121	—	231,121
General obligation bonds payable	2,090,105	—	126,800	1,963,305	129,360	1,833,945
Revenue bonds payable	22,943,536	1,583,149	1,714,176	22,812,509	942,911	21,869,598
Other long-term obligations	547,711	18,893	637	565,967	5,475	560,492
Total	**$ 28,040,530**	**$ 4,180,230**	**$ 4,363,671**	**$ 27,857,089**	**$ 1,763,835**	**$ 26,093,254**

NOTE 11: CERTIFICATES OF PARTICIPATION

Table 24 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 a state office building.

Table 24

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

Year Ending June 30	Principal	Interest	Total
2007	$ 6,994	$ 2,644	$ 9,638
2008	6,653	2,989	9,642
2009	6,410	3,228	9,638
2010	6,304	3,337	9,641
2011	6,449	3,192	9,641
2012-2016	41,580	9,528	51,108
Total	**$ 74,390**	**$ 24,918**	**$ 99,308**

Table 25 shows debt service requirements for certificates of participation for the University of California, a discretely presented component unit.

Table 25

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
2007	$ 3,840	$ 2,432	$ 6,272
2008	4,020	2,258	6,278
2009	2,175	2,126	4,301
2010	2,270	2,034	4,304
2011	1,015	1,967	2,982
2012-2016	5,760	9,146	14,906
2017-2021	7,300	7,603	14,903
2022-2026	9,430	5,475	14,905
2027-2031	12,175	2,726	14,901
2032-2036	2,830	149	2,979
Total	**$ 50,815**	**$ 35,916**	**$ 86,731**

NOTE 12: COMMERCIAL PAPER AND OTHER LONG-TERM BORROWINGS

The primary government has two commercial-paper-borrowing programs: a general obligation commercial paper program and an enterprise fund commercial paper program for the Department of Water Resources. Under the general obligation and enterprise fund programs, commercial paper may be issued at the prevailing market rate, not to exceed 11%, for periods not to exceed 270 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 and certain state water projects. For both commercial-paper-borrowing programs, the commercial paper is retired by the issuance of long-term debt, so commercial paper 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 $142 million. As of June 30, 2006, the enterprise fund commercial paper program had $129 million in outstanding notes.

During the year ended June 30, 2006, the primary government issued $4.0 billion in general obligation commercial paper and $3.8 billion in long-term general obligation bonds to refund outstanding commercial paper. However, by June 30, 2006, only $3.2 billion of the $3.8 billion had been used to repay outstanding commercial paper. The remaining $575 million was used to repay commercial paper in July and August 2006. As of June 30, 2006, the general obligation commercial paper program had $906 million in outstanding commercial paper notes, of which $575 million is considered a current liability. Of the $331 million noncurrent liability, $56 million is for business-type activities and the remainder is for governmental activities.

The primary government has a revenue bond anticipation note (BAN) program that consists of borrowing for capital improvements on certain California State University campuses. As of June 30, 2006, $46 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 $249 million, are various unsecured financing agreements, totaling approximately $139 million, with commercial banks.

The University of California has 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, 2006, outstanding tax-exempt and taxable commercial paper totaled $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, 2006, was approximately $8.0 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 $12 million from internal service funds and $4.5 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, 2006, amounted to approximately $779 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 $4.3 billion. This amount represents 96.5% 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 $606 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 26 summarizes future minimum lease commitments of the primary government.

Table 26

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
2007	$ 216,415	$ 2,003	$ 502,631	$ 721,049
2008	170,057	2,003	494,891	666,951
2009	125,444	2,006	481,061	608,511
2010	68,184	2,046	457,924	528,154
2011	34,941	2,055	430,958	467,954
2012-2016	106,700	3,955	2,038,732	2,149,387
2017-2021	16,821	—	1,597,917	1,614,738
2022-2026	759	—	850,280	851,039
2027-2031	335	—	377,399	377,734
2032-2036	355	—	—	355
2037-2041	95	—	—	95
2042-2046	95	—	—	95
2047-2051	95	—	—	95
2052-2056	91	—	—	91
2057-2061	44	—	—	44
Total minimum lease payments	**$ 740,431**	**14,068**	**7,231,793**	**$ 7,986,292**
Less: amount representing interest		1,947	2,777,086	
Present value of net minimum lease payments		**$ 12,121**	**$ 4,454,707**	

The aggregate amount of the major discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 2006, was approximately $3.6 billion. Table 27 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, 2006, amounted to approximately $223 million for major discretely presented component units.

Table 27

Schedule of Future Minimum Lease Commitments – Major 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
2007	$ 209,413	$ 94,015	$ 50,586	$ 354,014
2008	205,117	78,244	42,959	326,320
2009	206,963	63,539	31,277	301,779
2010	174,618	43,614	24,302	242,534
2011	168,358	29,914	17,466	215,738
2012-2016	836,563	36,227	17,671	890,461
2017-2021	634,173	3,334	—	637,507
2022-2026	401,784	3,622	—	405,406
2027-2031	230,960	4,067	—	235,027
2032-2036	—	4,641	—	4,641
2037-2041	—	3,692	—	3,692
Total minimum lease payments	**3,067,949**	$ **364,909**	$ **184,261**	**$ 3,617,119**
Less: amount representing interest	1,055,480			
Present value of net minimum lease payments	**$ 2,012,469**			

NOTE 14: COMMITMENTS

As of June 30, 2006, the primary government had commitments of $6.5 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 $3.0 billion from local governments and $3.5 billion in proceeds of approved federal grants. The ultimate liability will not accrue to the State. In addition, the primary government had commitments of $446 million for special education programs and $90 million for services provided under the welfare program that are not included in the reserve for encumbrances in the Federal Fund and will be reimbursed by the proceeds of approved federal grants.

The primary government had other commitments, totaling $29.6 billion, that are not included as a liability on the Balance Sheet or the Statement of Net Assets. These commitments included $10.6 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 $9.4 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 $29.6 billion in commitments also included grant agreements, totaling approximately $7.5 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 $1.1 billion for the construction of water projects and the purchase of power. Included in the $1.1 billion were certain

power purchase, sale, and exchange contracts with a fair value of $170 million as of June 30, 2006. The primary government also had commitments of $692 million for California State University construction projects, $165 million for the maintenance and operation of the California State Lottery's automated gaming system and its communication systems and services, and $125 million to veterans for the purchase of properties under contracts of sale. 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, 2006, 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 $2.7 billion. The university also made commitments to make investments in certain investment partnerships pursuant to provisions in the partnership agreements. These commitments totaled $615 million as of June 30, 2006. Other major component units had outstanding commitments to provide $320 million for loans under various housing revenue bond programs and $20 million to other governments for infrastructure improvements. In addition, the California Public Employees' Retirement System had capital commitments to private equity funds and to purchase real estate equity totaling $13.8 billion and $747 million, respectively, that remained unfunded and not recorded as liabilities on the Statement of Net Assets of either the fiduciary or discretely presented component units.

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; the General Fund 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, 2006, the State had $47.0 billion in outstanding general obligation bonds related to governmental activities and $2.0 billion related to business-type activities. In addition, $31.0 billion of general obligation bonds had been authorized but not issued. This amount includes $16.9 billion authorized by the applicable finance committees for issuance in the form of commercial paper notes. Of this amount, $906 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 issued variable-rate general obligation bonds. Prior to the 2005-06 fiscal year, the State had $2.4 billion of variable-rate general obligation bonds outstanding, consisting of $840 million in daily rate, $1.1 billion in weekly rate, and $500 million in auction rate. On November 16, 2005, the State sold an additional $1.0 billion of variable-rate general obligation bonds consisting of $150 million in daily rate and $850 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 during the 2003-04 fiscal year, expiration dates of the letters of credit for the daily and weekly variable-rate bonds have been amended to December 11, 2009, and December 31, 2015, 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. For the variable-rate bonds issued during the 2005-06 fiscal year, the initial expiration date of the letters of credit is November 17, 2010.

Based on the schedules provided in the Official Statements, sinking fund deposits for the variable-rate general obligation bonds will be set aside in a mandatory sinking fund at the beginning of each of the following fiscal years: the 2006-07 fiscal year, the 2015-16 through 2033-34 fiscal years, and the 2039-2040 fiscal year. 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 Economic Recovery Bond Sinking Fund, a debt service 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 Economic Recovery Bond Sinking Fund.

As of June 30, 2006, the State had $9.9 billion of Economic Recovery Bonds outstanding. Of the $9.9 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 outstanding $9.9 billion in Economic Recovery Bonds 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 28 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 28 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 28 shows the debt service requirements for all general obligation bonds as of June 30, 2006. The estimated debt service requirements for the $3.4 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, 2006.

Table 28

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

Year Ending	Governmental Activities			Business-type Activities		
June 30	Principal	Interest	Total	Principal	Interest	Total
2007	$ 1,792,430	$ 2,269,518	$ 4,061,948	$ 129,360	$ 106,440	$ 235,800
2008	1,925,308	2,193,605	4,118,913	136,430	96,618	233,048
2009	2,052,770	2,092,261	4,145,031	135,340	86,830	222,170
2010	2,195,625	1,983,817	4,179,442	118,190	77,557	195,747
2011	2,217,779	1,867,358	4,085,137	86,480	70,227	156,707
2012-2016	8,572,605	7,844,009	16,416,614	538,200	281,203	819,403
2017-2021	9,562,315	5,701,163	15,263,478	405,515	154,065	559,580
2022-2026	8,154,010	3,692,831	11,846,841	154,650	89,711	244,361
2027-2031	6,786,690	1,871,819	8,658,509	148,835	51,062	199,897
2032-2036	3,743,285	382,676	4,125,961	101,305	11,010	112,315
2037-2041	1,000	152	1,152	9,000	227	9,227
Total	**$ 47,003,817**	**$ 29,899,209**	**$ 76,903,026**	**$ 1,963,305**	**$ 1,024,950**	**$ 2,988,255**

D. General Obligation Bond Defeasances

1. Current Year

On September 21, 2005, the primary government issued $646 million in various-purpose general obligation refunding bonds in order to current-refund and advance-refund $646 million in general obligation bonds maturing in 2014 through 2028 and 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 defeased and the liability for those bonds has been removed from the financial statements. This refunding decreased overall debt service payments by $62 million and resulted in an economic gain of

$40 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 4.3% per year over the life of the new bonds.

On December 21, 2005, the primary government issued $518 million in Class-size Reduction Public Education Facilities general obligation refunding bonds in order to current-refund and advance-refund $515 million in general obligation bonds maturing in 2015 through 2026, 2028, and 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 refunding reduced debt service payments by $57 million and resulted in an economic gain of $29 million, using a discount rate of 4.5%.

On April 26, 2006, the primary government issued $238 million in various-purpose general obligation refunding bonds in order to advance-refund $231 million in general obligation bonds maturing in years 2015 through 2028 and 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 the bonds has been removed from the financial statements. This refunding reduced debt service payments by $23 million and resulted in an economic gain of $12 million, using a discount rate of 4.6%.

On June 28, 2006, the primary government issued $314 million in various-purpose general obligation refunding bonds in order to current-refund and advance-refund $307 million in general obligation bonds maturing in 2010 through 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 the bonds has been removed from the financial statements. This refunding reduced debt service payments by $42 million and resulted in an economic gain of $25 million, using a discount rate of 4.6%.

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, 2006, the outstanding balance of general obligation bonds defeased in prior years was approximately $2.2 billion.

NOTE 16: REVENUE BONDS

A. Governmental Activities

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. This bond funds activity in the Transportation Construction Fund and is 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, financing of electric power purchases for resale to utility customers, and certain nonmajor enterprise funds.

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

Table 29

Schedule of Revenue Bonds Outstanding
June 30, 2006
(amounts in thousands)

Primary government		
Governmental activities		
Transportation Construction Fund	$	525,460
Nonmajor governmental funds		
California State University Programs Fund		195,525
Golden State Tobacco Securitization Corporation Fund		5,993,758
Building authorities		585,895
Total governmental activities		**7,300,638**
Business-type activities		
Electric Power Fund		10,465,000
Water Resources Fund		2,389,333
Public Building Construction Fund		6,763,556
Nonmajor enterprise funds		3,194,620
Total business-type activities		**22,812,509**
Total primary government		**30,113,147**
Discretely presented component units		
University of California		6,014,385
California Housing Finance Agency		7,444,363
Nonmajor component units		584,590
Total discretely presented component units		**14,043,338**
Total	**$**	**44,156,485**

Table 30 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 29.

Table 30

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*
2007	$ 99,995	$ 389,952	$ 920,297	$ 1,044,941	$ 1,030,629	$ 626,908
2008	169,605	385,581	965,594	1,002,833	347,307	594,296
2009	131,765	379,774	1,019,263	962,571	369,113	579,073
2010	135,195	373,785	1,037,531	911,461	408,759	561,301
2011	136,710	374,278	1,076,535	857,827	387,886	548,867
2012-2016	581,255	1,772,750	6,001,865	3,455,035	2,068,366	2,415,545
2017-2021	607,615	1,649,223	6,813,003	1,991,312	2,124,610	1,920,759
2022-2026	279,779	1,670,079	3,099,760	775,804	2,187,124	1,403,885
2027-2031	265,844	1,582,005	1,483,835	263,021	2,327,841	883,648
2032-2036	1,620,310	1,216,517	361,835	58,663	1,712,211	388,164
2037-2041	1,635,555	763,887	68,295	4,817	890,664	75,418
2042-2046	1,637,010	279,493	—	—	—	—
Total	**$ 7,300,638**	**$ 10,837,324**	**$ 22,847,813**	**$ 11,328,285**	**$ 13,854,510**	**$ 9,997,864**

* Includes interest on variable-rate bonds based on rates in effect on June 30, 2006.

Table 31 shows debt service requirements as of June 30, 2006, for variable-rate debt included in Table 30, 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 31

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
2007	$ —	$ 147,000	$ (11,000)	$ 136,000	$ 50,872	$ 204,629	$ 25,725	$ 281,226
2008	—	147,000	(11,000)	136,000	101,323	213,320	18,171	332,814
2009	—	147,000	(11,000)	136,000	112,365	208,562	16,622	337,549
2010	—	147,000	(11,000)	136,000	116,813	203,154	15,967	335,934
2011	—	147,000	(11,000)	136,000	119,938	197,644	15,236	332,818
2012-2016	1,381,000	615,000	(43,000)	1,953,000	712,575	900,425	63,314	1,676,314
2017-2021	2,190,000	190,000	(8,000)	2,372,000	882,037	731,519	47,029	1,660,585
2022-2026	453,000	17,000	—	470,000	983,847	532,124	31,703	1,547,674
2027-2031	—	—	—	—	1,124,094	318,786	18,363	1,461,243
2032-2036	—	—	—	—	765,670	103,734	5,620	875,024
2037-2041	—	—	—	—	172,082	7,245	500	179,827
Total	**$ 4,024,000**	**$ 1,557,000**	**$ (106,000)**	**$ 5,475,000**	**$ 5,141,616**	**$ 3,621,142**	**$ 258,250**	**$ 9,021,008**

* Based on rates in effect on June 30, 2006.

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, which became effective February 13, 2003, and December 1, 2005, are summarized in Table 32. 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 positive fair value as of June 30, 2006, because interest rates had increased. 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, 2006, DWR was exposed to credit risk of $142 million because the majority of the swaps had positive fair values. The DWR has a total of 20 swap agreements with 10 different counterparties. Approximating 22% of the total notional value is held with a counterparty that has Moody's Investors Service, Fitch Ratings, and Standard & Poor's (S&P) credit ratings of Aa2, AA, and AA, respectively. Of the remaining swaps, two are held with a single counterparty and approximate 20% of the outstanding notional value; that counterparty has Moody's, Fitch's, and S&P's credit ratings of Aa3, AA-, and AA-, respectively. The remaining

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 32 summarizes the credit ratings of the counterparties for the swap agreements.

Table 32

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

Swap Termination Date	Outstanding Notional Amount at June 30, 2006	Fair Values at June 30, 2006	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	9,000	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	2,000	3.405	BMA	Aa3, AA-, A+
5/1/2013	30,000	—	3.405	BMA	Aa3, AA-, A+
5/1/2014	194,000	3,000	3.204	67% of LIBOR	Aa1, AA-, AA-
5/1/2015	355,000	10,000	3.184	66.5% of LIBOR	Aa3, AA-, AA-
5/1/2015	174,000	6,000	3.280	67% of LIBOR	Aaa, AAA, AAA
5/1/2016	202,000	7,000	3.342	67% of LIBOR	Aa2, AA, AA
5/1/2016	486,000	20,000	3.228	66.5% of LIBOR	Aa2, AA, AA
5/1/2017	202,000	7,000	3.389	67% of LIBOR	Aa3, AA-, A+
5/1/2017	480,000	20,000	3.282	66.5% of LIBOR	A2, AA-, AA-
5/1/2018	514,000	22,000	3.331	66.5% of LIBOR	A3, AA-, AA-
5/1/2020	306,000	13,000	3.256	64% of LIBOR	A3, AA-, AA-
5/1/2022	453,000	22,000	3.325	64% of LIBOR	Aa2, AA, AA-
Total	**$ 4,024,000**	**$ 147,000**			

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.

In June 2006, DWR entered into the basis swaps, shown in Table 33, effective July 1, 2006, to mitigate this risk and optimize debt service by changing the variable rate received by the Electric Power Fund to a five-year Constant Maturity Swap Index (CMS). The fair values were provided by the counterparties, using the par value or marked-to-market method.

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, 2006	Fair Values at June 30, 2006	Variable Rate Paid by Electric Power Fund	Variable Rate Received by Electric Power Fund	Counterparty Credit Ratings (Moody's, Fitch's, S&P's)
5/1/2012	$ 234,000	$ (1,000)	67% of LIBOR	62.83% of CMS	Aa2, AA, AA
5/1/2014	194,000	(1,000)	67% of LIBOR	62.70% of CMS	Aa3, AA-, AA-
5/1/2015	174,000	(1,000)	67% of LIBOR	62.60% of CMS	Aa3, A+, A+
5/1/2016	202,000	(1,000)	67% of LIBOR	62.80% of CMS	Aa2, AA, AA
5/1/2017	202,000	(1,000)	67% of LIBOR	62.66% of CMS	Aa3, A+, A+
Total	**$ 1,006,000**	**$ (5,000)**			

As of June 30, 2006, 67% of LIBOR paid on the basis swaps was equal to 3.58%, while the variable rates received based on the five-year CMS Index varied from 3.59 to 3.61%.

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, DWR would, at the time of the termination, 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, no rollover risk is 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 31 includes debt service requirements and net swap payments as of June 30, 2006, of the University of California (UC), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $340 million, $144 million, and negative $11 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 were made 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 positive fair value of $19 million as of June 30, 2006, because interest rates have increased 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, 2006. 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, 2006. 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 31 includes debt service requirements and net swap payments as of June 30, 2006, for the California Housing Finance Agency (CalHFA), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $4.8 billion, $3.5 billion, and $270 million, 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 the agency 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 $651 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 11 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 $28 million as of June 30, 2006. 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 129 swap transactions, with outstanding notional amounts of $4.9 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, 2006, the BMA rate was 3.97%, 65% of the one-month LIBOR was 3.47%, and 60% of the one-month LIBOR plus 26 basis points was 3.46%.

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.

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—Governmental Activities

In August 2005, the GSTSC issued Enhanced Tobacco Settlement Asset-Backed Bonds to advance-refund $2.6 billion in outstanding bonds. A portion of the proceeds was deposited into an escrow account to provide for all future debt service payments 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. Also, proceeds totaling $525 million were transferred to the State's general fund. Generally accepted accounting principles require disclosure of the economic gain or loss on advance refunding transactions. For this transaction, the State's Department of Finance indicates that no calculation of the economic gain or loss was performed because the debt service before the refunding and after the refunding were based on different sums of bonds as there was legislative authorization to extend the years of maturities that were financed.

In October 2005, the primary government issued $25 million in California State University Systemwide Revenue Bonds to advance-refund $26 million of the California State University Building Authority's outstanding lease revenue bonds. As a result, the refunded bonds are considered defeased and the liability for these bonds has been removed from the Building Authority's financial statements. The liability for the new bonds is included in the nonmajor enterprise fund financial statements. For a complete description of the refunding bonds issued, refer to the Current Year—Business-type Activities section below.

In December 2005, the San Francisco State Building Authority issued $201 million in lease revenue refunding bonds to advance refund $228 million in outstanding bonds. The net proceeds, together with other available monies, were deposited into an escrow account to provide for all future debt service payments 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. The refunding will reduce debt service payments by $49 million over the next 17 years and resulted in an economic gain of $10 million.

In December 2005, the Oakland State Building Authority issued $28 million in lease revenue refunding bonds to advance refund $37 million in outstanding bonds. The net proceeds, together with other available monies, were deposited into an escrow account to provide for all future debt service payments 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. The refunding will reduce debt service payments by $14 million over the next 17 years and resulted in an economic gain of $1.2 million.

2. Current Year—Business-type Activities

In July 2005, the primary government issued $112 million in Central Valley Project Water System Revenue Bonds, of which a portion of the proceeds was used to defease $105 million in outstanding bonds. The advance refunding resulted in the recognition of an accounting loss of approximately $5 million for fiscal year 2006. The primary government used the issuance of the Series AD bonds to provide debt service savings of approximately $11 million over the next 25 years, with a net present value of $6 million.

In August and October 2005, the primary government issued California State University Systemwide Revenue Refunding Bonds to defease certain outstanding California State University Housing System Revenue Bonds, Student Union Revenue Bonds, Parking Systemwide Revenue Bonds, Systemwide Revenue Bonds, and Headquarters Building Authority lease revenue bonds discussed in the Current Year—Governmental Activities section above. A portion of the proceeds was deposited into an escrow account to provide for all future debt service payments on the refunded bonds. As a result, the bonds are considered to be defeased and the liability for those bonds has been removed from the financial statements. The refunding will reduce debt service payments by $1 million over the life of the bonds and will result in an economic gain of $11 million.

In December 2005, the primary government issued $2.6 billion in variable-rate refunding revenue bonds to advance refund $2.4 billion in outstanding bonds. The advance refunding resulted in the recognition of an accounting loss of approximately $218 million, which has been deferred over the life of the refunded debt. The primary government used the issuance of the Series F and G bonds to provide debt service savings of approximately $278 million through 2022, with a net present value of $145 million.

During the year ended June 30, 2006, the primary government issued $470 million in lease revenue refunding bonds to advance refund $478 million in outstanding bonds. The primary government used the advance refunding to provide debt service savings of approximately $50 million over the next 14 to 18 years, with a net present value of $37 million.

3. Current Year—Discretely Presented Component Units

In July 2005, the University of California, a discretely presented component unit, issued $558 million in General Revenue Bonds; a portion of the proceeds from these bonds was used to refund $482 million in outstanding bonds. The university used the issuance of the bonds to provide debt service savings of approximately $7 million through 2035, with a net present value of $26 million. In April 2006, the Student Housing LLC, a legally separate, non-profit corporation included in the university's financial reporting entity, issued $99 million in Student Housing Refunding Revenue Bonds to refund $95 million in outstanding bonds. The LLC used the issuance of the bonds to provide debt service savings of approximately $8 million through 2038, with a net present value of nearly $4 million.

In November 2005, CalHFA, a discretely presented component unit, issued Multifamily Housing Revenue Bonds; a portion of the proceeds from these bonds was 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 term of bonds extinguished or the term of the refunding bonds, whichever is shorter. The refunding will decrease the debt

service cash outflow for Multifamily Programs by approximately $5 million. The refunding may also provide for an economic gain estimated to be approximately $8 million for the Multifamily Programs.

4. 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, 2006, the outstanding balance of revenue bonds defeased in prior years was approximately $468 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, 2006, the outstanding balance of University of California revenue bonds defeased in prior years was $940 million.

H. Related Organization Transaction

In April 2006, the Bay Area Toll Authority (BATA), a related organization, issued bonds to defease $1.2 billion in outstanding Bay Area Toll Bridges Seismic Retrofit Revenue Bonds that were issued by the California Infrastructure and Economic Development Bank. The bonds were secured and payable from the $1 per vehicle seismic surcharge from all toll-paying vehicles on the Bay Area bridges. However, in 2005 the California Legislature transferred toll administration responsibility, including the State's seismic dollar, from the State to BATA. Before the state-owned seismic dollar could be transferred to BATA, the outstanding Bay Area Toll Bridges Seismic Retrofit Revenue Bonds had to be defeased. Most of the proceeds from the bonds BATA issued were paid to Deutsche Bank National Trust Company to act as escrow agent for the defeased bonds. These proceeds will be invested and used to pay the principal and interest of the Bay Area Toll Bridges Seismic Retrofit Revenue Bonds as they become due. The payment from BATA to the escrow agent is shown as a special item on the government-wide Statement of Activities and the liability for the bonds has been removed from the government-wide Statement of Net Assets.

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 on which goods and services are provided and received and the dates on which 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, 2006
(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	$ —	$ —	$ 99,545	$ 161,154	$ —	$ —
Federal Fund	558,229	—	1,411,463	451,554	—	—
Transportation Construction Fund	—	—	—	7,011	—	—
Nonmajor governmental funds	143,961	—	206,717	562,400	—	—
Total governmental funds	**702,190**	**—**	**1,717,725**	**1,182,119**	**—**	**—**
Enterprise funds						
Water Resources Fund	—	—	—	—	—	—
Public Building Construction Fund	25,453	—	—	—	—	—
State Lottery Fund	353	—	—	322,910	—	—
Unemployment Programs Fund	15,724	230	—	7,083	—	—
Nonmajor enterprise funds	42,263	—	2,343	1,767	—	—
Total enterprise funds	**83,793**	**230**	**2,343**	**331,760**	**—**	**—**
Internal service funds	**8,925**	**124**	**27,889**	**178,295**	**33,000**	**5,349**
Fiduciary funds	**132,420**	**—**	**—**	**62**	**—**	**—**
Total primary government	**$ 927,328**	**$ 354**	**$ 1,747,957**	**$ 1,692,236**	**$ 33,000**	**$ 5,349**

Due To						
Public Building Construction Fund	State Lottery Fund	Unemployment Programs Fund	Nonmajor Enterprise Funds	Internal Service Funds	Fiduciary Funds	Total
$ —	$ —	$ —	$ —	$ 129,443	$ 4,605,656	$ 4,995,798
—	—	—	—	41,583	3,373,025	5,835,854
—	—	—	—	14,363	—	21,374
253	—	—	6,451	55,787	207,228	1,182,797
253	**—**	**—**	**6,451**	**241,176**	**8,185,909**	**12,035,823**
—	—	—	—	7,549	—	7,549
—	—	—	—	54,395	10,849	90,697
—	—	—	—	—	—	323,263
—	—	—	—	—	—	23,037
25,070	—	—	—	41	—	71,484
25,070	**—**	**—**	**—**	**61,985**	**10,849**	**516,030**
22,538	**5,640**	**36,927**	**21,278**	**53,742**	**15,634**	**409,341**
—	**—**	**—**	**—**	**—**	**268**	**132,750**
$ 47,861	**$ 5,640**	**$ 36,927**	**$ 27,729**	**$ 356,903**	**$ 8,212,660**	**$ 13,093,944**

Interfund receivables and payables are the result of interfund loans that are not expected to be repaid within one year. The $2.0 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, 2006
(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	$ —	$ —	$ 1,960,561	$ —	$ —	$ 1,054,674	$ 3,015,235
Nonmajor governmental funds	13,849	492,900	—	—	—	—	506,749
Total governmental funds	**13,849**	**492,900**	**1,960,561**	**—**	**—**	**1,054,674**	**3,521,984**
Enterprise funds	**715**	**—**	**—**	**—**	**2,246**	**—**	**2,961**
Internal service funds	**3,000**	**—**	**1,220**	**91,517**	**—**	**—**	**95,737**
Fiduciary funds	**35,341**	**—**	**—**	**—**	**—**	**—**	**35,341**
Total primary government	**$ 52,905**	**$ 492,900**	**$ 1,961,781**	**$ 91,517**	**$ 2,246**	**$ 1,054,674**	**$ 3,656,023**

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 on which goods and services are provided and received and the dates on which 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, 2006
(amounts in thousands)

	Due To			
Due From	**University of California**	**Public Employees' Benefits**	**Nonmajor Component Units**	**Total**
Governmental funds				
General Fund	$ 90,442	$ 11	$ —	$ 90,453
Nonmajor governmental funds	59,973	—	—	59,973
Total governmental funds	**150,415**	**11**	**—**	**150,426**
Enterprise funds	**12,170**	**—**	**—**	**12,170**
Internal service funds	**—**	**5,783**	**1,123**	**6,906**
Total primary government	**$ 162,585**	**$ 5,794**	**$ 1,123**	**$ 169,502**

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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 $1.5 billion for the support of trial courts and $680 million for traffic congestion relief. The $973 million transfer from the Federal Fund to the nonmajor governmental funds was primarily for the administration of the unemployment program. Table 37 presents interfund transfers of the primary government.

Table 37

Schedule of Interfund Transfers
June 30, 2006
(amounts in thousands)

	Transferred To		
Transferred From	**General Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**
Governmental funds			
General Fund	$ —	$ 408,306	$ 2,795,001
Federal Fund	—	—	973,498
Transportation Construction Fund	—	—	2,108
Nonmajor governmental funds	686,073	79,909	148,171
Total governmental funds	**686,073**	**488,215**	**3,918,778**
Enterprise funds			
Public Building Construction Fund	6,584	—	—
Nonmajor enterprise funds	31,681	—	4,808
Total enterprise funds	**38,265**	**—**	**4,808**
Internal service funds	**1,186**	**—**	**465**
Fiduciary funds	**105**	**—**	**—**
Total primary government	**$ 725,629**	**$ 488,215**	**$ 3,924,051**

Transferred To				
Unemployment Programs Fund	Public Building Construction Fund	Nonmajor Enterprise Funds	Internal Service Funds	Total
$ —	$ —	$ —	$ 227	$ 3,203,534
11,944	—	—	—	985,442
—	—	—	—	2,108
—	—	7,870	—	922,023
11,944	**—**	**7,870**	**227**	**5,113,107**
—	—	—	**—**	6,584
—	25,070	—	**—**	61,559
—	**25,070**	**—**	**—**	**68,143**
—	**—**	**—**	**—**	**1,651**
—	**—**	**—**	**—**	**105**
$ 11,944	**$ 25,070**	**$ 7,870**	**$ 227**	**$ 5,183,006**

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, 2006
(amounts in thousands)

	Governmental Funds	Internal Service Funds	Component Units
State-Local Realignment Fund	$ 1,413	$ —	$ —
Higher Education Construction Fund	858,160	—	—
Other capital projects funds	14,376	—	—
Architecture Revolving Fund	—	16,497	—
Public Employees' Benefits Fund	—	—	435,174
California Consumer Power and Conservation Financing Authority Fund	—	—	5,663
Total	**$ 873,949**	**$ 16,497**	**$ 440,837**

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, 2006, the total value of restricted and unrestricted endowments and gifts was $8.8 billion and $1.2 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 $1.5 billion at June 30, 2006. 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, no insurance settlement in the last three years 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 $2.6 billion as of June 30, 2006. 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 $3.6 billion is discounted to $2.6 billion using a 4% interest rate. Of the total, $314 million is a current liability, of which $197 million is included in the General Fund, $115 million in the special revenue funds, and $2 million in the internal service funds. The remaining $2.3 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 will occur 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 an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 4.5% to 6.0%. The other major 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	
	2006	**2005**	**2006**	**2005**
Unpaid claims, beginning	$ 2,807,718	$ 2,724,835	$ 561,827	$ 566,962
Incurred claims	111,023	455,108	213,604	250,264
Claim payments	(342,000)	(372,225)	(251,211)	(255,399)
Unpaid claims, ending	**$ 2,576,741**	**$ 2,807,718**	**$ 524,220**	**$ 561,827**

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 that 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, 2006

	High Technology Education	State University Dormitory Building Maintenance and Equipment
Assets		
Due from other funds	$ 626	$ 13,665
Due from other governments	—	—
Other current assets	74,485	1,007,429
Capital assets	—	1,862,869
Other noncurrent assets	365,015	17,768
Total assets	**$ 440,126**	**$ 2,901,731**
Liabilities		
Due to other funds	$ 25,070	$ 25,764
Due to other governments	—	—
Other current liabilities	30,216	131,601
Noncurrent liabilities	287,662	2,103,220
Total liabilities	**342,948**	**2,260,585**
Net assets		
Investment in capital assets, net of related debt	—	—
Restricted	97,178	441,395
Unrestricted	—	199,751
Total net assets	**97,178**	**641,146**
Total liabilities and net assets	**$ 440,126**	**$ 2,901,731**

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

Year Ended June 30, 2006

Operating revenues	$ 26,508	$ 462,484	
Depreciation expense	—	(103,600)	
Other operating expenses	(30,871)	(388,314)	
Operating income (loss)	(4,363)	(29,430)	
Nonoperating revenues	—	49,747	
Capital contributions	—	—	
Transfers in	—	7,410	
Transfers out	(25,070)	(4,808)	
Change in net assets	(29,433)	22,919	
Total net assets, July 1, 2005	**126,611**	**618,227**	*
Total net assets, June 30, 2006	**$ 97,178**	**$ 641,146**	

Condensed Statement of Cash Flows

Year Ended June 30, 2006

Net cash provided (used) by:			
Operating activities	$ 38,964	$ 85,119	
Noncapital financing activities	—	2,548	
Capital and related financing activities	(36,910)	103,380	
Investing activities	—	44,117	
Net increase (decrease)	**2,054**	**235,164**	
Cash and pooled investments at July 1, 2005	**50,992**	**739,896**	*
Cash and pooled investments at June 30, 2006	**$ 53,046**	**$ 975,060**	

* Restated

State Water Pollution Control	Housing Loan	Total
$ 4,560	$ 5,622	$ 24,473
163,040	—	163,040
404,984	499,299	1,986,197
—	1,721	1,864,590
1,990,349	1,644,717	4,017,849
$ 2,562,933	**$ 2,151,359**	**$ 8,056,149**
$ 631	$ —	$ 51,465
—	765	765
26,942	109,160	297,919
240,551	1,809,503	4,440,936
268,124	**1,919,428**	**4,791,085**
—	1,720	1,720
667,281	230,211	1,436,065
1,627,528	—	1,827,279
2,294,809	**231,931**	**3,265,064**
$ 2,562,933	**$ 2,151,359**	**$ 8,056,149**

$ 50,390	$ 124,812	$ 664,194
—	(807)	(104,407)
(10,487)	(138,181)	(567,853)
39,903	(14,176)	(8,066)
4,410	2,921	57,078
56,942	—	56,942
—	—	7,410
—	—	(29,878)
101,255	(11,255)	83,486
2,193,554	**243,186**	**3,181,578**
$ 2,294,809	**$ 231,931**	**$ 3,265,064**

$ 52,871	$ (45,488)	$ 131,466
21,683	(48,667)	(24,436)
—	—	66,470
12,006	462	56,585
86,560	**(93,693)**	**230,085**
318,323	**561,133**	**1,670,344**
$ 404,883	**$ 467,440**	**$ 1,900,429**

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, 2006, these component units had $18.5 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, 2006, the special-purpose trusts had approximately $922 million 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, 2006; legal proceedings that were in progress as of June 30, 2006, and were settled or decided against the primary government as of February 21, 2007; and legal proceedings having a high probability of resulting in a decision against the primary government as of February 21, 2007, 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 is a defendant in *Guillen v. Governor Schwarzenegger.* Petitioners in this certified class action contend that Governor Schwarzenegger's repeal of the Vehicle License Fee offset triggered a cost-of-living adjustment (COLA) increase for all CalWORKs beneficiaries pursuant to Welfare and Institutions Code section 11453(c)(3). The COLA amounts to approximately $10 million per month from October 2003 to the present. In addition, petitioners seek prejudgment interest. The superior court denied respondents' petition and entered judgment for the State. Although the State prevailed in the Court of Appeal, a petition to review will likely be filed.

The primary government is a defendant in *Northwest Energetic Services, LLC v. Franchise Tax Board.* The primary issue in this case is whether a fee imposed pursuant to Revenue and Taxation Code section 17942 on

a limited liability company (LLC) that is registered in the state, but does not conduct any business in the state, is unconstitutional because it is measured by the LLC's "total income from all sources reportable to the state." Northern Energetic Services alleges that assessing a fee measured by all of its income violates its due process and equal protection rights as well as the Commerce Clause of the United States Constitution. *Ventas Finance I LLC v. Franchise Tax Board* raises the same issues, but unlike Northwest, Ventas did conduct some business in the state. Both trial courts found the fees to be unconstitutional. Franchise Tax Board is appealing. Although the refunds of fees in these cases are less than $100,000, the State imposed $218 million in fees on LLCs in 2003. There has been 14% annual growth in the fees since 2003, which means that the potential refund-exposure exceeds $1.0 billion if the cases are adversely decided on appeal. To date more than 20,000 claims have been filed for more than $300 million.

A test claim filed on behalf of all California counties, based on a precedential County of San Diego case, regarding certain unreimbursed costs for the care of medically indigent adults (MIAs) is now pending before the Commission on State Mandates. 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 San Bernardino 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 County of San Diego case.

The University of California (UC), the State Compensation Insurance Fund (SCIF), the California Housing Finance Agency (CalHFA) 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, and CalHFA are of the opinion that the outcome of such matters either will not 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

Two retirement systems, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), 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, 2006. 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 when 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 1,483 public agencies as of June 30, 2006. 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 $26.6 billion at June 30, 2005. This is a result of the difference between the actuarial value of assets of $183.7 billion and the actuarial accrued liability of $210.3 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 employees, California Highway Patrol employees, peace officers and firefighters, and other safety members. The payroll for primary government employees covered by the PERF in the year ended June 30, 2006, was approximately $13.6 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 and the State's Alternative Retirement Program, 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, 2006

	Normal Cost	Unfunded Liability	Group Term Life Benefit	Total Rate
Miscellaneous members				
First tier	9.927 %	5.903 %	0.112 %	15.942 %
Second tier	9.875	5.903	0.112	15.890
Industrial (first and second tier)	13.870	3.164	0.113	17.147
California Highway Patrol	15.210	11.122	0.064	26.396
Peace officers and firefighters	17.478	6.029	0.056	23.563
Other safety members	14.994	3.932	0.100	19.026

For the year ended June 30, 2006, the annual pension cost (APC) and the amount of contributions made by the primary government were each $2.4 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, 2005, 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, 2006. The payroll for employees covered by the JRF for the year ended June 30, 2006, was approximately $122 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, 2006, 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, 2006, 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, 2006, were $189 million and $121 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 2006, was $1.19 billion, an increase of $68 million over last year's balance of $1.13 billion. The APC is comprised of $195 million for the annual required contribution (ARC), $79 million for interest on the NPO, and $85 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, 2005, is shown in Table 42. The aggregate cost method that was used for the June 30, 2005, 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, 2006, was approximately $121 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, 2006, the required member rate for the JRF II was 8.0%, and the primary government's contribution rate for the JRF II was 19.85% 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, 2006, the annual pension cost (APC) and the amount of contributions made for the JRF II were approximately $24 million. The APC and the percentage of APC contributed for the year ended June 30, 2006, are shown in Table 42. Information on the last valuation, which was performed as of June 30, 2005, 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, 2006, was approximately $2 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, 2006, contributions made by employees were not required because the plan was superfunded. By definition, "superfunded" means that 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, 2006, 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, 2005, is also shown in Table 42. The aggregate cost method that was used for the June 30, 2005, 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 54 fire departments participating in the VFF for the year ended June 30, 2006.

The actuarial accrued liability of the VFF exceeded the actuarial value of assets by $439,000 at June 30, 2005. This is a result of the difference between the actuarial accrued liability of $3.7 million and the actuarial value of assets of $3.2 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. As a result of negotiation provisions in the bargaining unit contract, the State suspended monthly contributions for rank and file employees and only continued contributions for managers and supervisors. 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, 2006, contributions by the primary government to the SPOFF were approximately $8.9 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, 2006, 34,485 participants belonged to the SPOFF.

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, 2006, the DB Program had approximately 1,350 contributing employers and as of June 30, 2005, had 574,676 active and inactive program members and 201,241 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, 2006, was approximately $24.9 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, 2006, the CB Program had 30 contributing school districts and 24,679 contributing participants.

Funding Policy: DB Program benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Members and employers contribute 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 2005-06, 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, 2005, 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, 2006, 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, 2006, the annual pension cost (APC) for the DB Program was approximately $3.8 billion; the employer and primary government contributions were approximately $2.1 billion and $348 million, 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 at least 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, 2006, the VIP had 448 participating employers (school districts) and 3,629 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, 2006, there were 6,087 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, valuation of the DB Program.

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Table 42

Actuarial Information – Pension Trusts – Primary Government
Valuation Date As Indicated

	Public Employees' Retirement Fund	Judges' Retirement Fund	Judges' Retirement II Fund
Last actuarial valuation	June 30, 2005	June 30, 2005	June 30, 2005
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	23 to 28 years	None	Average of 29 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 6/30/04	$ 2,121	$ 191	$ 19
Year ended 6/30/05	2,480	184	21
Year ended 6/30/06	2,419	189	24
Percent contribution			
Year ended 6/30/04	100 %	57 %	102 %
Year ended 6/30/05	100	69	100
Year ended 6/30/06	100	64	100
Net pension obligation (NPO) (in millions)			
Year ended 6/30/04	—	$ 1,069	—
Year ended 6/30/05	—	1,127	—
Year ended 6/30/06	—	1,195	—
Funding as of last valuation (in millions)			
Actuarial value – assets	$ 71,830	N/A	$ 168
Actuarial accrued liabilities (AAL) – entry age	86,595	N/A	178
Excess of actuarial value of assets over AAL (EAV) (unfunded actuarial accrued liability (UAAL))	(14,765)	N/A	(10)
Covered payroll	13,790	N/A	112
Funded ratio	82.9 %	N/A	94.3 %
EAV (UAAL) as percent of covered payroll	107.1 %	N/A	9.1 %

* 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 NPO does not apply to cost-sharing employer plans. According to the provisions of the Education Code, the State and local government employers contributed $348 million and $2.1 billion, respectively, for the year ending June 30, 2006. Based on the most recent actuarial valuation, dated June 30, 2005, 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 *
June 30, 2005	June 30, 2005
Aggregate Cost	Entry Age Normal
None	Level % of Payroll, Open
None	Not amortizable
Smoothed Market Value	Expected Value, With 33% Adjustment to Market Value
7.00 %	8.00 %
3.25	4.25
3.00	3.25
3.00	2.00
—	$ 3,410
—	3,709
—	3,821
— %	69 %
—	70
—	64
$ 10	—
10	—
10	—
N/A	$121,882
N/A	142,193
N/A	(20,311)
N/A	23,257
N/A	85.7 %
N/A	87.3 %

NOTE 24: POST-RETIREMENT HEALTH CARE BENEFITS

The primary government and certain discretely presented component units provide health care and dental benefits 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, 2006, approximately 131,000 annuitants were enrolled to receive health benefits and approximately 106,400 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, 2006, was approximately $888 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 41,000 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, 2006, was $211 million.

NOTE 25: SUBSEQUENT EVENTS

The following information describes significant events that occurred subsequent to June 30, 2006, but prior to the date of the auditor's report.

The primary government issued $1.9 billion in general obligation bonds to retire previously issued commercial paper, to repay internal state loans, and to finance various school, water, park, library, seismic, transportation, and children's hospital projects. The primary government also issued $359 million in veterans' general obligation bonds to retire previously issued commercial paper and to finance and refinance homes and farms for California military veterans. The primary government also issued revenue anticipation notes of $1.5 billion that are due to be redeemed in June 2007.

The Regents of the University of California issued $1.1 billion in General Revenue Bonds to finance and refinance certain facilities and projects of the university. Proceeds were used to refund outstanding Multiple Purpose Project Revenue Bonds, Research Facilities Revenue Bonds, and Certificates of Participation. It also issued $537 million in Medical Center Pooled Revenue Bonds to finance and refinance certain improvements to each of the five medical centers.

The California State University issued a Revenue Bond Anticipation Note in the amount of $26 million for a construction project. They also issued $180 million in capital lease obligations to finance and refinance certain campus construction projects. The California State University Auxiliary Organizations, a discretely presented

component unit, issued $2 million of commercial paper for capital financing to specific campuses and refinanced $20 million of outstanding commercial paper for the same capital financing program.

The Department of Veterans Affairs issued $144 million in Home Purchase Revenue Bonds to refund outstanding bonds which were issued to finance the purchase of homes and farms for California military veterans. The department also issued $92 million in Home Purchase Revenue Bonds to remarket outstanding variable-rate bonds to convert them to fixed-rate bonds.

The State Public Works Board, an agency whose activities are accounted for as an enterprise fund, issued lease revenue bonds totaling $467 million for the benefit of the University of California and various state agencies. Of the bond proceeds, $300 million will be used to refund outstanding lease revenue bonds.

In November 2006, the primary government issued $31 million in Stem Cell Research and Cures Bond Anticipation Notes to private individuals and philanthropic foundations to finance stem cell research.

In the general election held on November 7, 2006, voters approved the sale of $42.7 billion in general obligation bonds with the passage of the following five propositions.

- $19.9 billion for Proposition 1B, the Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006
- $2.9 billion for Proposition 1C, the Housing and Emergency Shelter Trust Fund Act of 2006
- $10.4 billion for Proposition 1D, the Kindergarten-University Public Education Facilities Bond Act of 2006
- $4.1 billion for Proposition 1E, the Disaster Preparedness and Flood Prevention Bond Act of 2006
- $5.4 billion for Proposition 84, the Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006

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, 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)
June 30, 2005	71,830	86,595	(14,765)	82.9	13,790	(107.1)

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, 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)
June 30, 2005	167,556	177,761	(10,205)	94.3	111,767	(9.1)

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, 2003	$ 108,667	$ 128,104	$ (19,437)	84.8 %	$ 22,649	(85.8) %
June 30, 2004	114,094	134,677	(20,583)	84.7	22,591	(91.1)
June 30, 2005	121,882	142,193	(20,311)	85.7	23,257	(87.3)

[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.

*Actuarial Accrued Liability and Covered Payroll figures for 2003 and 2004 were revised on an estimated basis in 2006 to reflect data corrections.

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 method 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, 2006, are in the following categories and amounts: state highway infrastructure (completed highway projects), totaling $55.7 billion; land purchased for highway projects, totaling $11.3 billion; and infrastructure construction-in-progress (uncompleted highway projects), totaling $4.6 billion.

Donation and Relinquishment: 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. There were no donations for the fiscal year ending June 30, 2006. Relinquishments for the fiscal year ending June 30, 2006, are $45 million of state highway infrastructure and $9 million of infrastructure land.

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 uses 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 through 2005-06 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%
2006	80.0%	94.5%

* 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, 2006.

BHI Description	Bridge Count	Percent	Network BHI
Excellent	6,515	53.75 %	99.9 %
Good	4,462	36.82	96.2
Acceptable	798	6.58	87.1
Fair	188	1.55	75.8
Poor	157	1.30	60.5
Total	**12,120**	**100.00 %**	

2. Roadways

The State uses AASHTO "Pavement Performance Data Collection Protocols" in its annual pavement condition survey, which evaluates ride quality and structural integrity and identifies 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 that the baseline is not exceeded.

The State's established condition baseline and the actual distressed lane miles for fiscal years 2003-04 through 2005-06 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 %
2006	18,000	13,845	27.9 %

* 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, 2006.

Pavement Condition	Lane Miles	Distressed Lane Mile
Excellent/Good	35,716	—
Fair	249	249
Poor	13,596	13,596
Total	**49,561**	**13,845**

C. Budgeted and Actual Preservation Costs

The State provides only budgeted and actual preservation costs starting with the fiscal year ending June 30, 2004, instead of the last five fiscal years because the information was not previously required required by GASB. 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.

The estimated budgeted preservation costs represents the preservation projects approved by the California Transportation Commission and the State's scheduled preservation work for each fiscal year. The actual preservation costs represents the cumulative cost to date for the projects approved and work scheduled in each fiscal year.

Fiscal Year Ending June 30	Estimated Budgeted Preservation Costs (in millions)	Actual Preservation Costs (in millions)
2004	$ 975	$ 934
2005	$ 1,049	$ 983
2006	$ 2,025	$ 1,495

Budgetary Comparison Schedule

General Fund and Major Special Revenue Funds

Year Ended June 30, 2006
(amounts in thousands)

	General			
	Budgeted Amounts		Actual	Variance With
	Original	Final	Amounts	Final Budget
REVENUES				
Corporation tax	$ —	$ —	$ 10,316,467	$ —
Intergovernmental	—	—	—	—
Cigarette and tobacco taxes	—	—	118,021	—
Inheritance, estate, and gift taxes	—	—	3,786	—
Insurance gross premiums tax	—	—	2,202,328	—
Vehicle license fees	—	—	24,878	—
Motor vehicle fuel tax	—	—	—	—
Personal income tax	—	—	50,324,822	—
Retail sales and use taxes	—	—	27,580,980	—
Other major taxes and licenses	—	—	320,697	—
Other revenues	—	—	2,991,110	—
Total revenues	**—**	**—**	**93,883,089**	**—**
EXPENDITURES				
State and consumer services	549,804	555,205	552,063	3,142
Business and transportation	14,305	1,372,800	1,372,531	269
Resources	1,034,887	1,170,638	1,146,735	23,903
Health and human services	27,202,688	27,473,946	26,421,808	1,052,138
Correctional programs	7,272,348	7,725,069	7,660,778	64,291
Education	43,060,000	46,007,068	45,959,264	47,804
General government:				
Tax relief	2,009,334	2,004,626	2,000,423	4,203
Debt service	3,236,209	3,242,509	3,210,691	31,818
Other general government	3,900,274	3,922,397	3,762,679	159,718
Total expenditures	**88,279,849**	**93,474,258**	**92,086,972**	**1,387,286**
OTHER FINANCING SOURCES (USES)				
Transfers from other funds	—	—	226,271	—
Transfers to other funds	—	—	(269,609)	—
Other additions and deductions	—	—	187,725	—
Total other financing sources (uses)	**—**	**—**	**144,387**	**—**
Excess (deficency) of revenues and other sources over (under) expenditures and other uses	—	—	1,940,504	—
Fund balances (deficits), July 1, 2005 (restated)	**—**	**—**	**9,315,015**	**—**
Fund balances (deficits), June 30, 2006	**$ —**	**$ —**	**$ 11,255,519**	**$ —**

Federal				Transportation Construction			
Budgeted Amounts		Actual	Variance With	Budgeted Amounts		Actual	Variance With
Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
—	—	40,744,195	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	3,393,381	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	938,560	—
—	—	1,506	—	—	—	243,312	—
—	**—**	**40,745,701**	**—**	**—**	**—**	**4,575,253**	**—**
29,873	29,873	29,873	—	—	—	—	—
3,308,451	3,308,451	3,308,451	—	4,432,486	4,581,316	4,291,600	289,716
187,441	187,441	187,441	—	12	12	12	—
27,325,179	27,325,179	27,325,179	—	—	—	—	—
22,796	22,796	22,796	—	—	—	—	—
6,949,389	6,949,389	6,949,389	—	980	980	980	—
—	—	—	—	—	—	—	—
—	—	—	—	—	500	284	216
1,144,784	1,144,784	1,144,784	—	2,006,823	1,635,724	1,633,768	1,956
38,967,913	**38,967,913**	**38,967,913**	**—**	**6,440,301**	**6,218,532**	**5,926,644**	**291,888**
—	—	5,093,589	—	—	—	6,496,797	—
—	—	(6,858,950)	—	—	—	(6,053,938)	—
—	—	(813)	—	—	—	167,351	—
—	**—**	**(1,766,174)**	**—**	**—**	**—**	**610,210**	**—**
—	—	11,614	—	—	—	(741,181)	—
—	**—**	**(3,061)**	**—**	**—**	**—**	**3,299,033**	**—**
$ —	**$ —**	**$ 8,553**	**$ —**	**$ —**	**$ —**	**$ 2,557,852**	**$ —**

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

June 30, 2006
(amounts in thousands)

		Special Revenue Funds	
	General	Federal	Transportation Construction
Budgetary fund balance reclassified into GAAP statement fund structure	**$ 11,255,519**	**$ 8,553**	**$ 2,557,852**
Basis difference:			
Interfund receivables	52,905		492,900
Loans receivable	99,640	40,986	—
Interfund payables	(1,960,561)	—	—
Escheat property	(1,054,674)	—	—
Other	2,915	—	391,471
Timing difference:			
Liabilities budgeted in subsequent years	(5,722,929)	(15,099)	(70,930)
GAAP fund balance, June 30, 2006	**$ 2,672,815**	**$ 34,440**	**$ 3,371,293**

Notes to the Required Supplementary Information

Budgetary Comparison Schedule

The State annually reports its financial condition based on Generally Accepted Accounting Principles (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, 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 $53 million increase to the fund balance in the General Fund and a $493 million increase to the fund balance in the Transportation Construction Fund. The adjustments related to loans receivable caused increases of $100 million in the General Fund and $41 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 $2.0 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 $1.1 billion decrease to the General Fund balance.

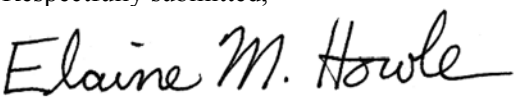
Other: Certain other adjustments and reclassifications are necessary in order to present the financial statements in accordance with GAAP. The other adjustments caused a fund balance increase of $3 million in the General Fund and $391 million in the Transportation Construction Fund.

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 $5.7 billion in the General Fund, $15 million in the Federal Fund, and $71 million in the Transportation Construction Fund. The large decrease in the General Fund primarily consists of $1.9 billion for deferred apportionment payments to K-12 schools and community colleges, $805 million of tax amnesty program overpayments, and $1.4 billion for medical assistance.

We conducted this audit to comply with Section 8546.4. of the California Government Code. The Independent Auditor's Report provides the opinions we expressed on the State of California's basic financial statements.

Respectfully submitted,



ELAINE M. HOWLE
State Auditor

Date: March 28, 2007

Part Two

State of California Internal Control and State and Federal Compliance Audit Report for the Year Ended June 30, 2006

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AUDITOR’S SECTION

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

ELAINE M. HOWLE
STATE AUDITOR

DOUG CORDINER
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, 2006, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated February 21, 2007. Our report was modified to include a reference to 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. As described in our report on the State of California's financial statements, other auditors audited the financial statements of the following:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 82 percent, 42 percent, and 52 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 89 percent, 79 percent, and 86 percent, respectively, of the assets, net assets, and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 69 percent, respectively, of the assets, net assets, and additions of the fiduciary funds and similar component units.

- The discretely presented component units noted above.

This report does not include the results of the other auditors' testing of internal control over financial reporting and compliance and other matters that are reported on separately by those auditors.

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 an opinion 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 initiate, record, process, 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 2006-19-2 and 2006-19-3.

A material weakness is a reportable 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 caused by error or fraud 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 grant agreements, 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 an instance of noncompliance that is required to be reported under *Government Auditing Standards* and which is described in the accompanying schedule of findings and questioned costs as Item 2006-19-1.

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 21, 2007

ELAINE M. HOWLE
STATE AUDITOR

DOUG CORDINER
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, 2006. 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. We did not audit the State of California's compliance with the requirements of the U.S. Environmental Protection Agency's Capitalization Grants for Clean Water State Revolving Funds (CFDA Number 66.458). This program, which accounts for less than 1 percent of the total federal assistance received by the State of California, is included in the accompanying schedule of findings and questioned costs and schedule of federal assistance. Other auditors have audited the State of California's compliance with this program's requirements and their report thereon has been furnished to us. Our opinion, insofar as it relates to this program, is based solely on the report of the other auditors.

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, 2006. The University of California and the California State University systems, and the California Housing Finance Agency, which reported expenditures of federal awards totaling $3.2 billion and $1.3 billion, and $74 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).

Except as discussed in the following paragraph, 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 and the reports of the other auditors provide a reasonable basis for our opinion. Our audit does not provide a legal determination of the State of California's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the State of California's compliance with the level of effort—maintenance of effort requirements applicable to the Special Education—Grants to States program (CFDA Number 84.027) and to the earmarking requirements applicable to the Maternal and Child Health Services Block Grant to the States program (CFDA Number 93.994), nor were we able to satisfy ourselves as to the State of California's compliance with those requirements by other auditing procedures.

As described in the Table below and in the accompanying schedule of findings and questioned costs, the State of California did not comply with requirements that are applicable to the following programs:

Table

Finding Number	Federal Department	Program	Catalog of Federal Domestic Assistance	Compliance Requirement
2006-1-1 & 2006-1-2	Health and Human Services	Medicaid Cluster: State Medicaid Fraud Control units, Hurricane Katrina Relief, State Survey and Certification of Health Care Providers and Suppliers, Medical Assistance Program	93.775 93.776 93.777 93.778	Allowable Costs
2006-2-1	Health and Human Services	Centers for Disease Control and Prevention—Investigations and Technical Assistance	93.283	Allowable Costs
2006-5-2	Health and Human Services	Medicaid Cluster: State Medicaid Fraud Control units, Hurricane Katrina Relief, State Survey and Certification of Health Care Providers and Suppliers, Medical Assistance Program	93.775 93.776 93.777 93.778	Eligibility
2006-7-3	Homeland Security	State Domestic Preparedness Equipment Support Program	97.004	Earmarking
2006-7-4	Education	Title I Grants to Local Educational Agencies, Safe and Drug-Free Schools and Communities-State Grants, Education Technology State Grants, English Language Acquisition Grants, Improving Teacher Quality State Grants	84.010 84.186 84.318 84.365 84.367	Maintenance of Effort—Level of Effort
2006-8-3	Health and Human Services	Child Care Development Fund Cluster: Child Care and Development Block Grant and Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.575 93.596	Period of Availability
2006-9-1	Homeland Security	Hazard Mitigation Grant	97.039	Procurement, Suspension and Debarment
2006-9-2	Education	Migrant Education-State Grant Program, Special Education Cluster: Special Education-Grants to States and Special Education-PreSchool Grants and Comprehensive School Reform Demonstration	84.011 84.027 84.173 84.332	Procurement, Suspension and Debarment
2006-12-3	Health and Human Services	Child Care Development Fund Cluster: Child Care and Development Block Grant and Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.575 93.596	Reporting

Finding Number	Federal Department	Program	Catalog of Federal Domestic Assistance	Compliance Requirement
2006-12-9	Education	English Language Acquisition Grants	84.365	Reporting
2006-13-2	Justice	Crime Victim Assistance	16.575	Subrecipient Monitoring
2006-13-3	Homeland Security	Disaster Grants—Public Assistance (Presidentially Declared Disasters), Hazard Mitigation Grant	97.036 97.039	Subrecipient Monitoring
2006-13-8	Education	Comprehensive School Reform Demonstration	84.332	Subrecipient Monitoring
2006-13-13	Health and Human Services	Immunization Grants	93.268	Subrecepient Monitoring
2006-13-17	Environmental Protection Agency	Capitalization Grants for Clean Water State Revolving Funds	66.458	Subrecipient Monitoring
2006-14-1	Health and Human Services	Medicaid Cluster: State Medicaid Fraud Control Units, Hurricane Katrina Relief, State Survey and Certification of Health Care Providers and Suppliers, Medical Assistance Program	93.775 93.776 93.777 93.778	Special Tests and Provisions—Provider Eligibility
2006-14-2	Agriculture	Special Supplemental Nutrition Program for Women, Infants, and Children (WIC)	10.557	Special Tests and Provisions—Review of Food Instruments to Enforce Price Limitations and Detect Errors

Compliance with such requirements is necessary, in our opinion, for the State of California to comply with the requirements applicable to those programs.

In our opinion, except for the effects of noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the State of California's compliance with the requirements of the Special Education—Grants to States (CFDA Number 84.027) regarding level of effort-maintenance of effort and the Maternal and Child Health Services Block Grant to the States (CFDA Number 93.994) regarding earmarking requirements as described in items 2006-7-5 and 2006-7-8, respectively, and except for the noncompliance described in the Table, 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, 2006. 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 as items 2006-2-2, 2006-3-1, 2006-3-2, 2006-3-5, 2006-3-6, 2006-3-7, 2006-3-8, 2006-3-9, 2006-3-10, 2006-3-11, 2006-3-16, 2006-5-1, 2006-7-1, 2006-7-7, 2006-8-1, 2006-12-1, 2006-12-2, 2006-12-6, 2006-12-7, 2006-12-8, 2006-12-10, 2006-13-1, 2006-13-12, 2006-13-14, 2006-13-16, and 2006-13-17.

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 as items 2006-1-1, 2006-1-2, 2006-1-4, 2006-1-5, 2006-1-6, 2006-2-1, 2006-2-2, 2006-3-1, 2006-3-2, 2006-3-3, 2006-3-4, 2006-3-5, 2006-3-6, 2006-3-7, 2006-3-8, 2006-3-9, 2006-3-10, 2006-3-11, 2006-3-12, 2006-3-13, 2006-3-14, 2006-3-16, 2006-5-1, 2006-5-2, 2006-5-4, 2006-5-5, 2006-7-1, 2006-7-2, 2006-7-3, 2006-7-4, 2006-7-5, 2006-7-7, 2006-7-8, 2006-8-1, 2006--8-2, 2006-8-3, 2006-8-4, 2006-9-1, 2006-9-2, 2006-9-4, 2006-12-1, 2006-12-2, 2006-12-3, 2006-12-4, 2006-12-5, 2006-12-6, 2006-12-7, 2006-12-8, 2006-12-9, 2006-13-1, 2006-13-2, 2006-13-3, 2006-13-4, 2006-13-5, 2006-13-6, 2006-13-7, 2006-13-8, 2006-13-9, 2006-13-10, 2006-13-12, 2006-13-13, 2006-13-14, 2006-13-15, 2006-13-16, 2006-14-1, 2006-14-2, 2006-14-3, 2006-14-4, 2006-14-5, and 2006-14-7.

A material weakness is a reportable 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 caused by error or fraud 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, of the reportable conditions described above, we consider items, 2006-1-1, 2006-1-2, 2006-2-1, 2006-3-1, 2006-5-2, 2006-7-3, 2006-7-4, 2006-7-8, 2006-8-3, 2006-9-1, 2006-9-2, 2006-12-3, 2006-12-9, 2006-13-2, 2006-13-3, 2006-13-8, 2006-13-13, 2006-14-1, and 2006-14-2 to be 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, 2006, and have issued our report thereon dated February 21, 2007. 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 82 percent, 42 percent, and 52 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 89 percent, 79 percent, and 86 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 69 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.

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 21, 2007

Schedule of Findings and Questioned Costs

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2006

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?	Yes
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Type of reports the auditor issued on compliance for major programs:	
Special Supplemental Nutrition Program for Women, Infants, and Children (10.557)	Qualified
Crime Victim Assistance (16.575)	Qualified
Capitalization Grants for Clean Water State Revolving Funds (66.458)	Qualified
Title I Grants to Local Educational Agencies (84.010)	Qualified
Migrant Education—State Grant Program (84.011)	Qualified
Special Education Cluster: Special Education Grants to States, Special Education Pre-school Grants (84.027 and 84.173)	Qualified
Education Technology State Grants (84.318)	Qualified
Comprehensive School Reform Demonstration (84.332)	Qualified
English Language Acquisition Grants (84.365)	Qualified
Improving Teacher Quality State Grants (84.367)	Qualified
Immunization Grants (93.268)	Qualified

Centers for Disease Control and Prevention—Investigations and Technical Assistance (93.283)	Qualified
Child Care Development Fund Cluster: Child Care and Development Block Grant, Child Care Mandatory and Matching Funds of the Child Care and Development Fund (93.575 and 93.596)	Qualified
Medicaid Cluster: State Medicaid Fraud Control Units, Hurricane Katrina Relief, State Survey and Certification of Health Care Providers and Suppliers, Medical Assistance Program (93.775, 93.776, 93.777, and 93.778)	Qualified
Maternal and Child Health Services Block Grant to States (93.994)	Qualified
State Domestic Preparedness Equipment Support Program (97.004)	Qualified
Disaster Grants-Public Assistance (Presidentially Declared Disasters) (97.036)	Qualified
Hazard Mitigation Grants (97.039)	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	$70.4 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 Development Fund Cluster
	Employment Services Cluster
	Food Stamp Cluster
	Highway Planning and Construction Cluster
	Highway Safety Cluster
	Medicaid Cluster
	Special Education Cluster
	Student Financial Aid Cluster
10.557	Special Supplemental Nutrition Program for Women, Infants, and Children
10.665	Schools and Roads—Grants to States
12.401	National Guard Military Operations and Maintenance (O&M) Projects
16.575	Crime Victim Assistance
17.225	Unemployment Insurance
66.458	Capitalization Grants for Clean Water State Revolving Funds
66.468	Capitalization Grants for Drinking Water State Revolving Funds
84.010	Title I Grants to Local Educational Agencies
84.011	Migrant Education—State Grant Program
84.126	Rehabilitation Services—Vocational Rehabilitation Grants to States
84.181	Special Education—Grants for Infants and Families with Disabilities
84.318	Education Technology State Grants
84.332	Comprehensive School Reform Demonstration
84.365	English Language Acquisition Grants
84.367	Improving Teacher Quality State Grants
84.369	Grants for State Assessments and Related Activities
93.268	Immunization Grants
93.283	Centers for Disease Control and Prevention—Investigations and Technical Assistance
93.556	Promoting Safe and Stable Families
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
93.667	Social Services Block Grant
93.674	Chafee Foster Care Independence Program
93.767	State Children's Insurance Program
93.917	HIV Care Formula Grants
93.994	Maternal and Child Health Services Block Grant to the States
96.001	Social Security—Disability Insurance
97.004	State Domestic Preparedness Equipment Support Program
97.036	Disaster Grants—Public Assistance (Presidentially Declared Disasters)
97.039	Hazard Mitigation Grant

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

VARIOUS STATE DEPARTMENTS

Reference Number: 2006-19-1

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 employees' taxable 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 employees' taxable benefits and reimbursements at one previously unreviewed state department for fiscal year 2005–06 in addition to following up on concerns we reported for other departments for fiscal year 2004–05. We summarize the results of this testing in the table below.

We reviewed 164 travel expense claims at the Department of Housing and Community Development (Housing) to determine whether the department properly reported employees' taxable reimbursements. However, not all of these travel expense claims included claims for taxable benefits. Housing did not always ensure that it met the reporting requirements the Controller's Office described.

We also determined if Housing issued vehicle home storage permits and reported the personal use of state vehicles to the Controller's Office. Housing did not always ensure that staff using their homes as headquarters, who would otherwise be exempt from reporting the personal use of state vehicles, kept required vehicle mileage logs. To review Housing's compliance with reporting requirements, we sampled four employees from Housing's Northern Region and six employees from its Southern Region. Housing believes that its employees in the Southern Region are exempt from reporting their personal commutes under the home-as-headquarters rule. To be exempt under this rule, the Controller's Office Payroll Procedures Manual describes specific conditions, including documentation of vehicle mileage logs, which need to be met. As the table also shows, our review determined that none of the six employees from the Southern Region maintained vehicle mileage logs, and therefore, did not meet the exemption requirements.

We reported similar concerns for fiscal year 2004–05 at seven other departments—the Department of Corrections and Rehabilitation, the Department of Fish and Game (Fish and Game), the Department of Health Services (Health Services), Secretary of State, State Personnel Board (Board), Commission on Peace Officer Standards and Training, and the Department of Industrial

Relations (Industrial Relations). We performed a follow-up review of the reporting of employees' taxable benefits and reimbursements at these state departments generally for March 2006 to June 2006, the period since our last review. Our review found that four of the seven departments continued to have reporting problems. Specifically, we reviewed from 71 to 111 travel expense claims at Fish and Game, Health Services and the Board and found that Fish and Game and Health Services again did not always report to the Controller's Office taxable fringe benefits arising from employees' travel and overtime expense reimbursements. We also found that Fish and Game, Industrial Relations, and the Board still did not always ensure that they reported the personal use of state vehicles to the Controller's Office.

TABLE

Reportable Items Reviewed That Were Not Reported to the Controller's Office in Fiscal Year 2005–06

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*
Department of Housing and Community Development	23	9	5	6†
Department of Fish and Game	14	NA	3	5
Department of Health Services	7	NA	9	0
Department of Industrial Relations	NA	NA	NA	6
State Personnel Board	21	NA	0	1
Totals	**65**	**9**	**17**	**18**

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.

† These six employees did not maintain vehicle logs, as Controller's Office procedures require.

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 incident to law enforcement functions and the actual facts and circumstances are documented.

- Section 129.1.3 also states that for the value of personal use of a state-owned or state-leased vehicle to be excluded from income for an employee whose home is designated as his/her headquarters, certain criteria, including documentation of vehicle mileage logs, must be met.

- 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 properly report taxable fringe benefits and taxable employee business expense reimbursements.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

Housing concurs with our finding and in July 2006, issued written instructions to ensure that overtime/call back mileage and taxable meals are reported to the Controller's Office. In June 2006, the department issued procedures to ensure that all field staff with assigned state vehicles turn in their mileage logs to their supervisors on a monthly basis.

Fish and Game concurs with our finding and states that it issued a bulletin to all employees in June 2006 to ensure that all appropriate taxable benefits are reported to the Controller's Office.

Health Services concurs with our finding and states that it implemented the California Automated Travel Expense Reimbursement System for all employees in June 2006. The system will automatically report taxable items to the Controller's Office.

Industrial Relations agrees with our finding. Industrial Relations plans to periodically review home storage permit records, mileage logs, and personal-use of state-owned vehicles to ensure proper reporting.

The Board concurs with our finding. The Board states that it has developed, and distributed to staff, written procedures to provide guidance on properly reporting taxable fringe benefits and taxable employee business reimbursements. The Board also states that it has provided training to its staff and that they follow the written procedures. In addition, the Board states that internal audits will be conducted quarterly to ensure compliance with applicable requirements.

DEPARTMENT OF FISH AND GAME

Reference Number: 2006-19-2

CONDITION

For the fiscal year ending June 30, 2005, 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 valued at 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 through 2005–06, 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. Effective October 1, 2006, the Department of Finance authorized a position in Fish and Game's Business and Contracts Management Branch to be responsible for tracking land, building and fixed asset acquisitions.

Fish and Game indicates it is reviewing each capital outlay expenditure to determine if it is a department asset or non-department asset. Non-department assets will be recorded as work in progress and then either removed or capitalized from the Property Inventory Database. Guidelines for identifying these assets are being developed and should be in operation by June 30, 2007. Further, Fish and Game reports that its Accounting Services Branch is recording information monthly on the additions and deletions of real property and is reporting this information annually in the Statement of Changes in General Fixed Assets to the Controller's Office.

Further, Fish and Game reports that it is working with the board to develop a methodology to accurately reflect land purchases into the Property Inventory Database. In addition, it is also conducting training to assist staff in recognizing which acquisition costs associated with land purchases should be included in capital assets. Finally, it is working with the board to coordinate land purchase information in order to improve communication regarding these purchases, to reduce errors, avoid duplication of record-keeping, and assist in correct documentation of Fish and Game's property inventory. With these actions, Fish and Game expects that it will be able to accurately report its capital assets by June 2008.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2006-19-3

CONDITION

For 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 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 Services' 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 September 2006 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, which now total $7.9 million through fiscal year 2005-06, and whether it reconciles the amounts reported in the Statewide Property Inventory with its records. Parks and Recreation informed us it has now reported the $7.9 million in ancillary costs of real property acquired in fiscal years 2001–01 through 2005–06, and reports ancillary costs to General Services in a format that allows input into the Statewide Property Inventory system. In September 2006, Parks and Recreation also informed us that it has not fully implemented our prior year's recommendation to reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets and that the difference between the two sources was $239 million. Because Parks and Recreation has not fully implemented our recommendation to reconcile the amounts reported, we did not review its progress in reporting ancillary costs.

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 departments 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 it has made progress in addressing the recommendation, but additional time is necessary for full implementation. Specifically, Parks and Recreation reported $7.9 million in ancillary cost for acquisitions from fiscal years 2000–01 through 2005–06 to General Services. It believes these figures are now in a form acceptable to the Statewide Property Inventory system. Parks and Recreation also indicates that it continues to reconcile its records of assets. Parks and Recreation believes that due to the extent of research necessary for each item to be reconciled, it may take several years to complete the reconciliation.

Compliance Issue Related to All Federal Grants

IDENTIFYING PROGRAM EXPENDITURES

Reference Number:	2006-12-10
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 173) 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 three such programs. Our review of the expenditures of these programs showed that two of them exceeded the Type A threshold. However, only one of the two was high risk and required an audit.

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 comply with federal and State requirements. At this time Finance has received approval for a new integrated statewide financial management system, the Financial Information System for California. Finance is currently pursuing the funding for the project through the legislative process. It is anticipated that the new system will have the capability to provide total expenditures for each federal program.

Compliance and Internal Control Issues Related to Specific Grants Administered by Federal Departments

Bureau of State Audits

U.S. DEPARTMENT EDUCATION

Reference Number:	2006-3-1
Federal Catalog Number:	84.298
Federal Program Title:	State Grants for Innovative Programs
Federal Award Number and Calendar Year Awarded:	S298A050005; 2005
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 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 80.21 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 Innovative Education program demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disbursed $16.6 million, or 80 percent, of Innovative Education's fiscal year 2005–06 entitlements without first assessing each subrecipient's immediate cash needs. Additionally, Education did not ensure that these subrecipients had spent the $24 million they reported in June 2005 as having carried over from their fiscal year 2004–05 disbursements. This did not occur because Education does not have a process in place to request the balance of unspent funds from previous years before disbursing current-year funds—in this case, the fiscal year 2005–06 funds disbursed in June 2006. As a result of this weakness, Education has no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should establish and implement procedures to assess each subrecipient's cash needs and, if necessary, adjust payments to subrecipients 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 Innovative Education cash balances and expected costs for the upcoming payment period. Education then would advance only enough Innovative Education 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

The local education agencies (subrecipients) report year-to-date expenditures on the Consolidated Application for Title V Innovative Education. However, Education continues to develop processes for establishing minimum spending thresholds and assessing each subrecipient's cash needs before the release of additional funds.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Although Education requires subrecipients to report expenditures in the consolidated application, Education does not require them to report expenditures related to their spending of carryover balances identified in prior years' applications. Thus, Education is not acquiring the information it needs to determine whether its subrecipients fully used the balances before disbursing additional funds.

Reference Number:	2006-7-1
Federal Catalog Number:	84.181
Federal Program Title:	Special Education—Grants to Infants and Families with Disabilities
Federal Award Number and Calendar Year Awarded:	H181A040037; 2004
Category of Finding:	Level of Effort—Maintenance of Effort
State Administering Department:	Department of Developmental Services

CRITERIA

Our review of the Special Education—Grants for Infants and Families with Disabilities program (Early Start Program) identified the following requirements related to level of effort:

The Code of Federal Regulations, Title 34, Section 303.124(b), specifies that the total amount of state and local funds budgeted for expenditure in the current fiscal year for early intervention services for children eligible under Part C of the Individuals with Disabilities Education Act and their families must be at least equal to the total amount of state and local funds actually expended for early intervention services for these children and their families in the most recent preceding fiscal year for which the information is available. Allowances may be made for (1) decreases in the number of children eligible to receive early intervention services under Part C and (2) unusually large amounts of funds expended for such long-term purposes as the acquisition of equipment and the construction of facilities.

CONDITION

The Department of Developmental Services (Developmental Services) does not have a system in place to demonstrate that it maintains funding under the Early Start Program for early intervention services for children and their families at a level that is at least equal to the funding for the prior

year. According to the manager of the Children and Family Services Branch, in previous years, the state funds budgeted for the Early Start Program steadily increased because of a continuous increase in the number of participants; thus, Developmental Services believes it has met the maintenance of effort requirements.

Although Developmental Services provided us with documentation to support the steady increase of participants in the Early Start Program through June 2006, there is currently no budget specifically assigned to this program that can measure whether the state funds spent increased with the rise in the number of participants in this program. By not tracking and fully demonstrating that it is meeting this requirement, Developmental Services could lose some of its federal funding for the Early Start Program.

RECOMMENDATION

Developmental Services should implement a system for annually monitoring its compliance with the maintenance of effort requirement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Developmental Services does not agree with the finding that "The Department of Developmental Services does not have a system in place to demonstrate that it maintains funding under the Early Start Program for early intervention services for children and their families at a level that is at least equal to the funding for the prior year."

The Developmental Services' Information Services Division (ISD) reports quarterly data per the population served and the expenditures for children in the Early Start program. This quarterly reporting commenced in fiscal year 2000–01. Additionally, ISD can conduct point-in-time data runs as requested to produce expenditure and census data to demonstrate California's ongoing maintenance of effort. As reflected in the data table provided to the audit team, California's annual per capita amount increased 65% since fiscal year 1995-96 for children served in the Early Start program (from $2,720 to $4,696). This per capita increase in expenditures is in conjunction with an increase of 120% in the 0-3 population served in the program. This contrasts with a 32% decrease in the federal per capita share during this same time period ($2,338 to $1,586). Developmental Services contends that it has a strong system in place to clearly and dramatically demonstrate maintenance of effort for this program.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We disagree with Developmental Services' statement that it has a strong system in place to demonstrate it has met its maintenance of effort requirement. When we initially requested Developmental Services to describe to us how it annually monitors its compliance with this requirement, it was unable to do so. In fact, according to the manager of the Children and Family Services Branch, a precise mathematical demonstration of maintenance of effort is unwarranted. However, without a mathematical calculation, it is not possible to monitor whether Developmental Services is meeting this requirement.

Furthermore, although Developmental Services indicates in its view and corrective action plan that it provided us with a table demonstrating it is meeting the maintenance of effort requirement, it did not prepare the table until October 19, 2006, which is after we had completed our fieldwork. Moreover, our review of this table found it to be insufficient for purposes of monitoring its

maintenance of effort for several reasons. First, the table does not contain data for fiscal year 2005–06, which is the period under audit. Second, the table includes only a portion of the state's funds used for this program and excludes others, such as state funds spent on administration; thus, the table is incomplete. Finally, the case load data included in the table is significantly more than the case load data reported on the Departmental Services' website, which also calls into question the accuracy of the table.

Reference Number:	2006-7-2
Federal Catalog Number:	84.298
Federal Program Title:	State Grants for Innovative Programs
Federal Award Number and Calendar Year Awarded:	S298A050005; 2005
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, 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.

However, we independently performed procedures to determine whether Education met the supplement—not—supplant requirement for Innovative Education. Although there is a lack of controls at the state level to ensure compliance, we found that Education appears to have met the requirements.

RECOMMENDATION

Education should implement a process to monitor, at the state level, whether the revenues from Innovative Education supplement other funding for grant-related activities.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Program activity accounts are maintained in Education's accounting and budget systems. These accounts reflect the appropriations as approved by the state legislature in the Budget Act, and the actual expenditures as reported on the certified annual year-end financial statements. The Budget Act delineates available funding from both federal and state programs.

Education also maintains subsidiary spreadsheets that track and list program appropriations and expenditures from both the current and prior fiscal years. Fiscal and program staff utilize the spreadsheets to monitor program fiscal compliance by making sure designated programs' funding has not been eliminated or shifted to other funding sources (supplanting).

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We agree that Education maintains the data that would allow it to track whether it is using federal funds to supplement existing funds. However, although Education indicates staff is monitoring its compliance with the supplement–not–supplant requirement, it was unable to provide us with documentation to show that it is doing so.

Reference Number:	2006-13-1
Federal Catalog Number:	84.181
Federal Program Title:	Special Education—Grants to Infants and Families with Disabilities
Federal Award Number and Calendar Year Awarded:	H181A040037; 2004
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Developmental Services

CRITERIA

Our review of the Special Education—Grants for Infants and Families with Disabilities program (Early Start 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. Specifically, OMB Circular A-133, Section 400(d)(1) 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 (CFDA) title and number, award name and number, and name of the federal agency.

CONDITION

Developmental Services did not completely fulfill its subrecipient monitoring responsibilities for its Early Start Program. Specifically, although Developmental Services identifies the federal law and regulations that govern the Early Start Program, for the five subrecipients we reviewed, it did not provide the CFDA title and number, the award number, and the name of the Federal agency when awarding program funds through a contract. When Developmental Services does not fully identify the federal award information, it cannot ensure that subrecipients correctly identify all of the federal requirements of the Early Start Program. As a result, subrecipients' independent auditors who must conduct audits in accordance with OMB Circular A-133 may not be aware of all of the requirements they should test. According to its Assistant Section Chief of the Customer Support Section, Developmental Services was not aware of this federal requirement because the State's Contracting Manual does not address it. The State Contracting Manual is a resource that provides the policies, procedures, and guidelines to promote sound business decisions and practices in securing necessary services for the State. It does not eliminate or override federal requirements; therefore Developmental Services is still responsible to follow the federal requirements for subrecipient monitoring found in the OMB Circular A-133.

RECOMMENDATION

Developmental Services should ensure that it identifies and provides all required federal award information to subrecipients of the Early Start program at the time of the awards.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Developmental Services concurs with the finding and confirms that it will list the grant fund source on every subcipient contract. The Developmental Services' Customer Support Section is revising its internal contract request forms to require programs to indicate if the funding for the contracts is federal money. If yes, the program requesting the contract will have to indicate the Catalog of Federal Domestic Assistance title and number, award name and number, and name of the Federal Agency on the contract request forms. The Contract Analysts will then ensure that the information is included in the contract.

Reference Number:	2006-14-7
Federal Catalog Number:	84.032
Federal Program Title:	Federal Family Education Loans
Year Awarded:	State fiscal year 2005–06
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 its restriction of access to 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 it has made some progress in addressing this weakness. The auxiliary organization hired a contractor that completed a security risk assessment in June 2005, and in January 2007 management informed its employees via a policy memo that its entitywide security program plan shall apply to all employees, vendors, and third parties with access to the auxiliary organization's systems or information. However, the auxiliary organization has not yet addressed all of the high-risk and moderately high-risk findings identified in its risk assessment, nor has it fully implemented the entitywide security program plan. The lack of planning and management commitment has the potential to result in insufficient protection of sensitive or critical computer records.

The auxiliary organization also needs to strengthen its electronic access controls designed to restrict access to data files. Although the auxiliary organization had made some changes, it continued to allow a limited number of employees 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 these 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. We noted that the operating agreement for state fiscal years 2002–03, 2003–04, and 2004–05 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 its operating agreement with the auxiliary organization for fiscal year 2005–06 without adding any provisions to strengthen controls over information systems.

RECOMMENDATIONS

Student Aid's auxiliary organization should fully implement its entitywide program for security planning and management, and strengthen its electronic access controls. This will help ensure that it maintains current, complete, and accurate records for each loan it holds. In addition, Student Aid should amend the operating agreement with its auxiliary organization to specify its expectations related to the control structure over the information systems.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Entity-wide Security Planning and Management

An entity-wide security program plan was documented in late federal fiscal year 2005–06 and was further enhanced in early federal fiscal year 2006–07. Many elements of the plan are in place while others are continuing to be addressed by the auxiliary. A significant number of the high-risk and moderately high-risk findings identified in the June 2005 risk assessment have been mitigated, although, some remain to be addressed. The auxiliary is in the process of expanding its dedicated information security team by providing additional resources to better strengthen this function.

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 performed using data maintenance; modifications could be made which would provide a systematic process for performing these updates including the creation of an automated audit trail. Where readily practicable, modifications were made to certain processes that have eliminated the need for some data maintenance activity.

A process has been implemented to address updates/actions that the auxiliary determined could not readily be performed through a systematic process and, therefore, will continue to be performed through data maintenance. Specifically, the auxiliary has created logs that document all data maintenance updates that are currently occurring or requested. Information documented in the logs include 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 responsible for reviewing new types of data maintenance requests to ensure that there is no readily available systematic means to perform the change.

The limited number of employees performing data maintenance are designated by EdFund management to have system access to perform their job responsibilities which include data maintenance. The two divisions in which these individuals work have formal procedures for requesting, authorizing, and performing data maintenance changes which the employees are required to follow.

Additionally, EdFund's Internal Audit Department 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

Staff are currently drafting a new Operating Agreement for the Commission's review and approval. The Commission anticipates providing the draft agreement to the California Joint Legislative Budget Committee and the Department of Finance no later than May 1, 2007, to allow for a 45 day comment period. The Commission will then discuss any resulting comments and make revisions, if necessary, so that a new Operating Agreement can be in place by June 30, 2007.

The draft Operating Agreement provided to the Commission will include provisions to appropriately require the auxiliary to maintain strong control over its information systems including an audit of the information technology controls relevant to the Operating Fund and Federal Fund financial statements.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number:	2006-2-2
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0505CA5028; 2005
Category of Finding:	Allowable Costs and Cost Principles
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to allowable costs and cost principles:

The United States Code, Title 42, beginning with Section 1396, enables states to provide medical assistance to Medicaid beneficiaries and providers. Additionally, Public Law Number 107-300, the Improper Payments Information Act of 2002, defines an improper payment as a payment that should not have been made or that was made in an incorrect amount (including overpayments, underpayments, and duplicate payments) under statutory, contractual, administrative, or other legally applicable requirements by a federal agency, a federal contractor, or a governmental or other organization administering a federal program or activity. Finally, the Code of Federal Regulations, Title 42, sections 433.300 through 433.320, establishes the requirements for recovering overpayments from providers.

CONDITION

Electronic Data Systems (EDS)—the firm the Department of Health Services (Health Services) contracts with to authorize Medicaid payments—authorized Medicaid payments to some skilled nursing facilities (facilities) more than once for the same services. We identified these errors while performing an audit of California's implementation of a new facility-specific reimbursement rate system. Specifically, we identified more than 2,100 duplicate payments to facilities for claims reflecting dates of service between August 1, 2005, and July 31, 2006, totaling $3.3 million. We are also aware of other potential duplicate payments to facilities; however, due to the complexity of these payments, additional research by EDS is necessary. According to EDS, its examiners followed a flawed procedure that instructed them to override a specific type of suspended claim, resulting in duplicate payment authorizations.

Health Services and EDS have subsequently taken measures to resolve this problem. EDS has implemented a special processing guideline to discontinue overriding suspended claims, updated its procedures, and started to identify all facilities that received duplicate Medicaid payments to begin efforts to recoup those funds. However, subsequent to our audit, we found that its special processing guideline instructs examiners in certain situations to continue to follow the flawed procedure, which could result in EDS continuing to pay duplicate claims related to the skilled nursing facilities.

Because the scope of the audit described above focused on long-term care payments made to facilities subject to new reimbursement rates, we reviewed Health Service's guidelines for other types of payments and found that those for medical, outpatient, and vision payments included this same flawed procedure. However, because EDS does not document or track the reasons it overrides a suspended claim, we could not identify which claims were paid using the flawed procedure that could result in duplicate payments. Although we were not able to definitively determine which suspended claims were paid in this manner, we obtained information from EDS that indicates the number and dollar amount of those claims that could be subject to the flawed procedure. We have summarized this information in the table below. We did not assess the reliability of this information and its use should be limited to providing a proper context for our results.

TABLE

Number of Claims Suspended and Overridden That Were Potentially Subject to the Flawed Procedure in Fiscal Year 2005–06

	Suspended Claims		Claims Overridden and Paid	
Type of Claim	**Numbers**	**Amount**	**Number**	**Amount**
Long-term care	103,201	$188,845,801	12,151	$10,586,218
Medical	512,011	182,730,151	79,222	39,675,433
Outpatient	182,204	71,166,926	9,897	1,015,041
Vision	128	64,840	23	7,102
Totals	**797,544**	**$442,807,718**	**101,293**	**$51,283,794**

RECOMMENDATIONS

To ensure that EDS authorizes disbursements of Medicaid funds only to facilities and providers entitled to them, Health Services should take the following steps:

- Completely review and update its procedures and guidelines as necessary to ensure that examiners are not overriding system-generated errors inappropriately.
- Further investigate the possibility that duplicate payments were authorized by the contractor beyond those we specifically identified during our earlier audit to ensure that the magnitude of the problem is identified and corrected, and duplicate payments are recouped.
- Ensure that its contractor—EDS—documents and tracks the reasons for overriding claims that have been suspended in the system.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

To ensure that its contract consultant authorizes disbursements of Medi-Cal funds only to facilities entitled to them, Health Services should take the following steps:

Recommendation:

Completely review and update its procedures and guidelines as necessary to ensure that examiners are not overriding system-generated errors inappropriately.

Response:

The Department will review the error code criteria and systems processing guidelines and make any corrections needed to assure the error code instructions for overrides are clear and do not result in erroneous payments. Recoupment will be made for any additional mispayments identified.

Recommendation:

Further investigate the possibility that duplicate payments were authorized by the contractor beyond those we specifically identified during our earlier audit to ensure that the magnitude of the problem is identified and corrected, and duplicate payments are recouped.

Response:

The BSA audited the period August 1, 2005 to July 31, 2006. The Department expanded the paid claim investigation period (January 1, 2003 through November 2006) and has determined that duplicate payments were made from October 5, 2005 through November 18, 2006 for an approximate total of $6.1 million in overpayments affecting 648 providers. It should be noted that October 5, 2005 is the date the flawed Long-Term Care (LTC) suspense override procedure was implemented and November 18, 2006 was the date that Special Processing Guideline (SPG) number 648 was installed to correct the flawed override procedure. All overpayments will be collected from providers through the running of an Erroneous Payment Correction (EPC) process.

The Department will review all other claim types to determine if any mispayments have occurred related to this edit criteria and make any necessary changes in the processing instructions. Where mispayments are found, the Department will initiate recoupment from providers. In this research, the Department will refine the universe of claims which are potentially affected to include only claims with a Treatment Authorization Request (TAR) since only claims with an approved TAR are potentially subject to this issue.

Recommendation:

Ensure that its contractor-EDS-documents and tracks the reasons for overriding claims that have been suspended in the system.

Response:

The Department agrees to increase Quality Control over the claims override function. Although the specific reasons for override are not documented, all transactions applied to a claim are documented in CA-MMIS reports. These reports include the MR-O-154 Paid Full Status Non-Institutional, CP-O-02A Process Suspense Reentry Transaction Register, and CP-O-03A Daily Error Suspense List. Notably, the CP-O-02A and MR-O-154 reports document which examiner made an override transaction. These reports are retained for 10 years and additional audit trails for each claim processed. EDS also performs quality control reviews of each examiner and the EDS Quality Management Department performs monthly audits of claims processing which includes override transactions.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

While Health Services is able to recreate the decision the examiner may have made using various reports, unless the examiner documents the specific basis for the override, uncertainty remains. Further, an even better method for documenting decisions made by the examiners would be to create a field in the system that records the basis for overriding a suspended claim, which would allow EDS to sort and analyze the reasons electronically.

Reference Number:	2006-3-16
Federal Catalog Number:	93.563
Federal Program Title:	Child Support Enforcement
Federal Award Number and Calendar Year Awarded:	75-X-1501; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Child Support Services

CRITERIA

Our review of the Child Support Enforcement program (enforcement program) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 45, Section 92.21, prescribes the basic standard and methods under which a federal agency will make payments to grantees and grantees will make payments to subgrantees. The basic standard states that the methods and procedures for payment shall minimize the time elapsing between the transfer of funds and disbursements by the grantee or subgrantee in accordance with U.S. Treasury regulations included in the Code of Federal Regulations, Title 31, Part 205. Further, the Code of Federal Regulations, Title 45, Section 92.20(7), requires grantees to monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees. Additionally, Section 92.21(e) states that if a grantee cannot meet the criteria for an advance by minimizing the time between receipt and disbursement of federal funds and the federal agency has determined that reimbursement is not feasible because the grantee lacks sufficient working capital, the awarding agency may provide a working capital advance. This same section states that the working capital advance method of payment shall not be used by grantees or subgrantees if the reason for using such a method is the unwillingness or inability of the grantee to provide timely advances to the subgrantee to meet the subgrantee's actual cash disbursements.

CONDITION

The Department of Child Support Services (Child Support Services) did not have procedures in place to ensure that it limits the advances of federal funds to its subgrantee—the Judicial Council of California (Judicial Council)—to the minimum amounts needed for the enforcement program. Child Support Services enters into a cooperative agreement with the Judicial Council to coordinate the efforts of local courts in the ongoing operation of the statewide enforcement program. Under this

agreement, the Judicial Council requested from Child Support Services two advances of federal funds for fiscal year 2005–06, which it considers to be working capital advances. It received the first advance of $3 million in July 2005 and the second advance of $6 million in October 2005. The Judicial Council indicated that it requested the first advance to reimburse court invoices for July through October 2005 and the second for invoices from October 2005 through May 2006.

The Judicial Council believes it needs these advances for two reasons. First, it does not have the funds in its general fund to pay the local courts for their invoices before being reimbursed by Child Support Services. Second, in the past it took up to four months for Child Support Services to reimburse the Judicial Council for court invoices, which was not acceptable to the courts, especially the smaller ones. However, we identified the following problems with the advances provided to the Judicial Council:

- Child Support Services did not obtain the federal government's determination that the Judicial Council needs a working capital advance.

- Although the Judicial Council indicated that it believed a $6 million advance was reasonable because it represents approximately two months of local court expenditures, we did not find this to be the case during state fiscal year 2005–06. For example, for the months of November 2005 through January 2006, the three months after it received the $6 million advance, the amounts that Judicial Council requested from Child Support Services for the local courts' monthly expenditures were less than $1 million. Consequently, for these three months, at various points in time, the Judicial Council had at least $4 million and as much as $5.5 million in excess federal funds on hand. According to the Judicial Council, this occurred because it had not yet fully executed contracts with some of the courts; thus, it could not pay all the invoices submitted during these months. Once the contracts were executed in February 2006, it paid invoices totaling more than $13 million.

Finally, we question whether a working capital advance is appropriate when it is not unreasonable for the Judicial Council to obtain advances that correspond to its disbursement cycle. Additionally, as the Judicial Council acknowledges, it is difficult to obtain executed contracts in a timely manner, which can result in significant fluctuations in the amount of cash it needs. For example, during the months the contracts remain unsigned, the Judicial Council could estimate the amounts it believes it will be paying the courts that have executed contracts in place and request that amount in advance. In a subsequent month, it could adjust the advance to reflect actual expenditures while requesting a new advance for the next month to more closely reflect its disbursement cycle and ensure that it does not have cash on hand for extended periods of time.

RECOMMENDATIONS

Child Support Services should work with the Judicial Council to reassess the timing and amount of federal funds the Judicial Council needs in advance so the advances correspond as closely as possible to the actual expenditure activity. Additionally, Child Support Services should ensure that it promptly adjusts subsequent advances to reflect its reconciliation of earlier advances with actual expenditures. However, if Child Support Services believes the Judicial Council needs a working capital advance, it should obtain the federal government's determination on this matter.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Child Support Services agrees with the recommendations. It will work closely with Judicial Council to ensure that our advance process includes an evaluation of the initial advance amount as well as an ongoing process to minimize the time elapsing between transfer of funds and disbursement by Judicial Council. If it is determined that the advance process is not viable, we will seek federal approval to establish a working capital advance. The process to evaluate the advance is underway and Child Support Services expects to have revised procedures in place for state fiscal year 2007–08.

Reference Number:	2006-13-16
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Aging

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Aging Cluster grants identified the following compliance requirements related to subrecipient monitoring:

The United States Code, Title 42, Section 3027(a)(4), requires that the State conduct periodic evaluations of activities and projects authorized under Title III of the Older Americans Act. The Code of Federal Regulations, Title 45, Section 1321.3, defines "*periodic*" as, at a minimum, once each fiscal year. However, the U.S. Administration on Aging has agreed that the State can conduct onsite program monitoring reviews (program review) of the services provided by area agencies at least once every four years and onsite compliance reviews once every three years. Further, Section 1321.11 requires the State to establish policies that address the manner in which it will monitor the performance of all programs and activities funded by the Title III grants for quality and effectiveness. Finally, the State is responsible for enforcement of these policies.

CONDITION

The Department of Aging (Aging) is not adequately fulfilling all its monitoring responsibilities for the Area Agencies on Aging (area agencies). Specifically, while Aging was able to conduct eight onsite program reviews and 11 onsite compliance reviews for fiscal year 2005–06, we found the following:

- Aging did not promptly complete the final reports for the eight onsite program reviews. Aging's procedures require it to provide area agencies with a preliminary report of required corrective action (preliminary report) for its program reviews during the exit conference at the completion of its onsite visits. Additionally, Aging informs the area agencies in its preliminary report that it will send a final report to them, which includes Aging's recommendations for required corrective actions, within 120 days of the exit conference. However, as of December 14, 2006, Aging had not completed the final reports for seven of its onsite program reviews. Additionally, although it completed the final report for the eighth program review in October 2006, this exceeded the 120 days as required by its procedures by more than eight months.

- As of December 14, 2006, Aging had yet to complete the draft reports for 11 onsite compliance reviews. Aging informs area agencies that following a site visit for a compliance review, it issues a draft notice of audit determination and allows the area agency 30 days to provide additional information related to audit findings before issuing a final report. For example, during the exit conference held on January 13, 2006 for one of its 11 compliance reviews, Aging discussed with the area agency that it had preliminarily identified $2.3 million in questioned costs for the four years audited. However, because Aging did not promptly provide the area agency with its draft notice of audit determination and allow the area agency its opportunity to provide additional information related to the audit findings within 30 days, Aging had yet to determine the true amount of the questionable costs, almost one year later.

Because Aging is not following its procedures to promptly provide area agencies with its final and draft reports for its onsite reviews, Aging cannot ensure that area agencies submit corrective action plans and that area agencies are taking prompt and appropriate action to correct deficiencies.

RECOMMENDATION

To ensure that area agencies prepare corrective action plans and take prompt and appropriate action to correct deficiencies identified during program and compliance reviews, Aging should comply with its internal procedures related to promptly issuing reports to notify area agencies of deficiencies.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Onsite Program Reviews—The Department of Aging (Aging) does not agree with two statements in the finding. First, the finding states " . . . as of December 14, 2006, Aging had not completed the final reports for any of these reviews." The Department did issue a final report on October 20, 2006, for one of its eight onsite program reviews. Second, the finding states "Although Aging may have discussed deficiencies it identified during these reviews with the area agencies during the exit conference, Aging failed to provide the final or draft report that it informed the area agencies to expect." This statement implies that Aging only "discusses deficiencies" during exit conferences; in fact, at exit conferences, area agency directors are provided with a written copy of the "Report of Required Corrective Actions" signed and dated by Aging's Monitoring Team Policy Manager in charge of the review. This report documents the corrective actions required by the area agency to rectify any deficiencies and stresses the importance of using the report to begin implementing the corrective actions required to bring the area agency into compliance.

Staff is continuously working to improve the procedures that govern the monitoring protocols used by Aging to conduct onsite program reviews. We will work on streamlining processes to ensure the remaining seven reports are finalized within the current fiscal year.

Onsite Compliance Reviews (Audits)—Aging has had significant staff turnover during the past three years, including not having had an Audit Manager for 17 months, 12 of which were consecutive. This has resulted in the current backlog of reports.

Since these 11 onsite reviews were conducted, the auditors have been in contact with the area agencies seeking additional information to resolve the initially questioned costs. Frequently, this process, though lengthy, results in an immaterial amount finally being questioned in the report because the auditor is able to obtain documentation showing that costs were appropriate. During

this process of resolution, the auditors are also providing technical assistance to the area agencies that will help prevent recurrence in the future. The area agency has also begun progress toward corrective action and greater accountability even though the written report has not been issued.

The Department hired a permanent Audit Manager in late November, and subsequently the unit was fully staffed and two new auditors are being trained. As of the end of January 2007, the Audit Branch completed either draft or final reports for four of the 11 reviews and worked on streamlining processes to ensure the remaining seven reports are completed within the current fiscal year. In the meantime, Aging is also adopting procedures to ensure that area agencies are promptly notified in writing of their deficiencies following all future onsite compliance reviews and to ensure that the area agencies implement appropriate action to correct deficiencies.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We have revised our finding to reflect Aging's comments that it had completed the final report for one of the eight onsite program reviews and that it provides a "Report of Required Corrective Actions" to the area agencies at the exit conference. However, we would like to point out that several times during our fieldwork, we questioned Aging as to whether it had completed any of the final reports for these eight onsite program reviews, including during a final update meeting held in December 2006, when we discussed with Aging the details of this finding. During this meeting, Aging stood by its responses to our earlier inquiries that it had not completed nor distributed any of these final reports. In fact, it was not until February 2007, when we received its corrective action plan, that Aging informed us it had completed the one report and it provided us a copy of that report only upon our direct request.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

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:	05AACAT3SP; 2005 06AACAT3SP; 2006

Federal Catalog Number:	93.045
Federal Program Title:	Special Programs for the Aging—Title III, Part C—Nutrition Services
Federal Award Numbers and Calendar Years Awarded:	05AACAT3SP; 2005 06AACAT3SP; 2006

Federal Catalog Number:	93.053
Federal Program Title:	Nutrition Services Incentive Program
Federal Award Numbers and Calendar Years Awarded:	05AACANSIP; 2005 06AACANSIP; 2006

KPMG LLP

U.S. DEPARTMENT OF AGRICULTURE
Summary of Findings and Questioned Costs
June 30, 2006

Reference Number:	2006-14-2
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children (WIC)
Federal Award Number and Calendar Year Awarded:	7CA700CA7; 2006, 7CA700CA7; 2005
Category of Finding:	Special Tests and Provisions—Review of Food Instruments to Enforce Price Limitations and Detect Errors
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 7—AGRICULTURE, CHAPTER II—FOOD AND NUTRITION SERVICE (FNS), DEPARTMENT OF AGRICULTURE, PART 246—SPECIAL SUPPLEMENTAL NUTRITION PROGRAM FOR WOMEN, INFANTS AND CHILDREN—Subpart G—Miscellaneous Provisions Section 246.25 Records and reports.

- Recordkeeping requirements: Each State and local agency shall maintain full and complete records concerning Program operations. Such records shall comply with 7 CFR part 3016 and the following requirements:

  – Records shall include, but not be limited to, information pertaining to financial operations, food delivery systems, food instrument issuance and redemption, equipment purchases and inventory, certification, nutrition education, civil rights and fair hearing procedures.

  – All records shall be retained for a minimum of three years following the date of submission of the final expenditure report for the period to which the report pertains. If any litigation, claim, negotiation, audit or other action involving the records has been started before the end of the three-year period, the records shall be kept until all issues are resolved, or until the end of the regular three-year period, whichever is later. If FNS deems any of the Program records to be of historical interest, it may require the State or local agency to forward such records to FNS whenever either agency is disposing of them.

Condition:

The WIC Program obtained a waiver from the United States Department of Agriculture (USDA), which allowed the State Agency to destroy redeemed food instruments prior to the end of the regulated three-year retention period. However, this is contingent upon the ability to retrieve copies of these destroyed food instruments (up to three years after redemption) routinely and timely through existing banking records. The WIC Program is only able to retrieve copies of the food instruments redeemed up to one year ago. By not retaining copies or having the ability to obtain copies for the three-year retention period, Health Services is not in compliance with the recordkeeping requirements of the WIC Program.

Questioned Costs:

Not determined

Recommendations:

We recommend that WIC Program management resolve this matter by attempting to retain banking records of redeemed food instruments for three years. Management may consider working with banks to retain the information electronically. In addition, management should also clarify with federal agency representatives as to whether the electronic records of food instruments would satisfy the requirements.

Department's View and Corrective Action Plan:

Health Services concurs with the recommendations.

Health Services is researching the cost of retaining electronic bank records and capturing and storing images of redeemed food instruments for audit purposes. The two alternatives currently under consideration include:

1. Paying the State Treasurer's Office to retain source of receipt records linking each food instrument to the bank of deposit. Each bank of deposit is required by law to retain check images for seven years and will provide a check copy upon request for a $25 fee.

2. Paying the State Treasurer's Office to electronically capture an image of each food instrument and retain the image for retrieval as needed.

Health Services will complete its research and develop a draft implementation plan within the next 60 days. Health Services will request clarification from the USDA, Food and Nutrition Service, Western Region Office before final implementation of its plan.

U.S. DEPARTMENT OF JUSTICE

Summary of Findings and Questioned Costs
June 30, 2006

Reference Number:	2006-13-2
Federal Catalog Number:	16.575
Federal Program Title:	Crime Victim Assistance
Federal Award Number and Calendar Year Awarded:	2001-VA-GX-4006; 2001 2003-VA-GX-4025; 2003 2004-VA-GX-0009; 2004 2005-VA-GX-0052; 2005 2006-VA-GX-0049; 2006
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Governor's Office of Emergency Services (Emergency Services)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to federal awards provided to the subrecipient by the pass-through entity; and

TITLE 28—JUDICIAL ADMINISTRATION, CHAPTER I—DEPARTMENT OF JUSTICE, PART 66—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 66.40 Monitoring and reporting program performance. (a) Monitoring by grantees.

Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

Emergency Services did not adequately monitor its subrecipients of funds for the Crime Victim Assistance Program for the fiscal year ending June 30, 2006. According to the chief of its Grants Management Branch of Emergency Services, there is a backlog in performing the reviews and preparing management letters due to lack of staffing. Emergency Services has not reviewed an estimated combined 1,575 audit reports submitted by subrecipients dating back to 2002.

In addition, Emergency Services has not followed up with subrecipients who have not submitted their single audit reports. Further, Emergency Services does not have processes or controls in place to accurately track whether subrecipients' audit reports have been submitted or reviewed.

Emergency Services stated that it lacks sufficient staff to adequately monitor the receipt of the reports, review them, issue management decisions on the findings contained in them, and ensure that the subrecipients have taken timely and appropriate corrective action on all audit findings. Without performing these procedures, Emergency Services could not ensure that subrecipients were complying with federal program requirements.

Questioned Costs:

Not determined

Recommendations:

We recommend that Emergency Services develop a process to review subrecipient audit reports, respond and resolve findings noted in those reports, and ensure appropriate corrective action is taken within six months after receipt of the subrecipient report in accordance with Federal guidelines.

Department's View and Corrective Action Plan:

Emergency Services concurs with the finding and has implemented corrective action. An audit coordinator was hired in December 2006, and that person's responsibilities include the review of A-133 audit reports and the resolution of any findings in programs administered by Emergency Services. Emergency Services expects to complete the review of all backlogged reports, and be current on newly received reports, by June 30, 2007.

U.S. DEPARTMENT OF EDUCATION
Summary of Findings and Questioned Costs
June 30, 2006

Reference Number:	2006-1-5
Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005
Category of Finding:	Activities Allowed/Allowable Costs
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart E—How a Subgrant Is Made to an Applicant, Section 76.400 State procedures for reviewing an application.

A State that receives an application for a subgrant shall take the following steps:

(a) Review. The State shall review the application.

(b) Approval—entitlement programs. The State shall approve an application if:

- The application is submitted by an applicant that is entitled to receive a subgrant under the program; and
- The applicant meets the requirements of the Federal statutes and regulations that apply to the program.

(c) Approval—discretionary programs. The State may approve an application if:

- The application is submitted by an eligible applicant under a program in which the State has the discretion to select subgrantees;
- The applicant meets the requirements of the Federal statutes and regulations that apply to the program; and
- The State determines that the project should be funded under the authorizing statute and implementing regulations for the program.

(d) Disapproval—entitlement and discretionary programs. If an application does not meet the requirements of the Federal statutes and regulations that apply to a program, the State shall not approve the application.

Condition:

Education has a formal control process for approving awarding grants to Local Educational Agencies (LEAs). This process consists of multiple levels of Education approval, which are documented on a *Summary Cover Memo* (Form EXE-100f), by the program manager and director, the deputy, general counsel, government affairs and chief deputy, as appropriate, to approve the award to the LEA. These approved *Summary Cover Memos* are not retained as evidence of the controls in place over the grant award approval process. By not retaining the *Summary Cover Memos* as evidence of award approval, Education cannot demonstrate support for the proper approval of grants.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education retain copies of the *Summary Cover Memos* in the program department files as evidence of controls over the grant award approval process.

Department's View and Corrective Action Plan:

Education will retain copies of the *Summary Cover Memos*, indicating the required approvals, in the program office files as evidence of controls over the grant award approval process.

Reference Number:	2006-1-6
Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005
Category of Finding:	Activities Allowed/Allowable Costs
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart E—How a Subgrant is Made to an Applicant, Section 76.400 State procedures for reviewing an application.

A State that receives an application for a subgrant shall take the following steps:

(e) Review. The State shall review the application.

(f) Approval—entitlement programs. The State shall approve an application if:

- The application is submitted by an applicant that is entitled to receive a subgrant under the program; and

- The applicant meets the requirements of the Federal statutes and regulations that apply to the program.

(g) Approval—discretionary programs. The State may approve an application if:

- The application is submitted by an eligible applicant under a program in which the State has the discretion to select subgrantees;

- The applicant meets the requirements of the Federal statutes and regulations that apply to the program; and

- The State determines that the project should be funded under the authorizing statute and implementing regulations for the program.

(h) Disapproval—entitlement and discretionary programs. If an application does not meet the requirements of the Federal statutes and regulations that apply to a program, the State shall not approve the application.

Condition:

The program department has a formal control process for the approval of the Local Educational Agencies' (LEAs) application for use of program funds. This process consists of a review of the proposed activities by two program consultants. Evidence of the review of the consultants of the proposed activities is indicated on a reviewer's score sheet.

These program funds were issued to LEAs in grouping cycles entitled cohorts. During the fiscal year ended June 30, 2006 funds were paid for cohorts 3, 4, and 5. These reviewer score sheets were not retained by the program department for cohorts 3 or 4, nor were we able to obtain any other documented evidence to support the review and approval of applications for allowable activities. By not retaining the reviewer score sheets as evidence of review and approval of proposed grant activities, Education cannot demonstrate support for approval of activities.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education retain copies of these reviewer's score sheets with the LEAs applications in the program department files as evidence of controls over the approval of LEA activities.

Department's View and Corrective Action Plan:

To document approval of LEA activities, Education will retain copies of reviewer's score sheets and LEA applications in the program office files.

Reference Number:	2006-3-3
Federal Catalog Number:	84.010
Federal Program Title:	Title I, Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005

Federal Catalog Number:	84.027 & 84.173
Federal Program Title:	Special Education Cluster—Special Education Grants to States & Special Education Pre-School Grants
Federal Award Number and Calendar Year Awarded:	H027A050116 & H173A050120; 2005

Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Number and Calendar Year Awarded:	S318X050005; 2005

Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005

Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005

Federal Catalog Number:	84.369
Federal Program Title:	Grants for State Assessments and Related Activities
Federal Award Number and Calendar Year Awarded:	S369A050005; 2005

Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over claim payments made to subrecipients, we noted Education requests cash advances from the federal government and then requests payments to be made to the Local Educational Agencies (LEAs) by the State Controller's Office (SCO).

For the programs that are included in the Cash Management Improvement Act (CMIA) agreement between the U.S. Department of the Treasury and the State, we noted that the required pre-issuance funding technique for payments to local agencies requires the State to disburse cash advances to LEAs not more than three days after the advance is deposited in the State account. For programs that do not fall under the CMIA, Education has adopted an internal policy of 14 days as a reasonable amount of time between the advance of federal funds and disbursement made to LEAs.

Education has a control process in place to reconcile and follow up on a monthly basis any outstanding LEA payment requests submitted to the SCO from advanced federal funds that remain unpaid after 60 days. The practice of only following up on items after 60 days past due would not enable Education to determine whether or not it is in compliance with Federal requirements for minimizing the time elapsing between the request for advance from the Federal government and the payment being made to the subrecipient.

Without appropriately designed controls in place, Education risks payments not being made in accordance with Federal guidelines. We understand that Education is in the process of strengthening controls to ensure that reconciliations of any unpaid LEA payment requests are performed more timely.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen processes, controls, and communication with the SCO to reduce the amount of time before follow up is made on unpaid amounts.

Department's View and Corrective Action Plan:

For payment of claims, the procedures followed by Education fall either under those established by the Department of Finance (DOF) with agreement by the SCO for CMIA or those that follow the process governed by the California Prompt Payment Act. CMIA claims are paid within three days and for all others the SCO has 15 days in which to issue payment. In an effort to further strengthen existing controls, Education has changed the timeframe it waits to follow up on any outstanding claims to 30 days.

Reference Number:	2006-3-4
Federal Catalog Number:	84.010
Federal Program Title:	Title I, Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

Title 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart G—What are the Administrative Responsibilities of the State and Its Subgrantees? Section 76.702 Fiscal control and fund accounting procedures:

A State and a subgrantee shall use fiscal control and fund accounting procedures that insure proper disbursement of and accounting for Federal funds.

Condition:

Education has a formal control process for making payments to subrecipients. A *Claims Schedule* is prepared by the Fiscal Services Division Accounting Office for the amounts approved to be paid, which is input into the California State Accounting and Reporting System (CALSTARS) General Ledger. A supervisor reviews and approves the work performed by the staff by initialing the Claims Schedule. The original copy of the approved *Claims Schedule* is sent to the State Controller's Office (SCO) to be paid, however a copy of the approved Claims Schedule is not retained as evidence of the review and approval process for the claim. An unsigned copy of the Claims Schedule is retained along with the other documentation as support for the payment. By not retaining the signed copy as evidence of review and approval of the payment request data entry into CALSTARS, Education can not demonstrate support for proper approvals of payments made to LEAs.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education retain copies of the approved *Claims Schedule* instead of the unapproved *Claims Schedule* as part of the supporting documentation package as evidence of controls over the payment approval process.

Department's View and Corrective Action Plan:

Although the State Controller's Office has signature cards on file and will not process a claim for payment unless the original claim is reviewed and signed by authorized personnel, Education will retain copies of claim schedule face sheets that the accounting staff have initialed to indicate approval.

Reference Number:	2006-3-5
Federal Catalog Number:	84.010
Federal Program Title:	Title I, Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish

reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over payments made to subrecipients, we noted Education does not have a process in place for assessing the cash needs of its subrecipients. Education requests advance funds from the Federal government and makes three predetermined payment advances to Local Educational Agencies (LEAs) during the fiscal year. Education does not require periodic expenditure reporting or input by the LEAs during the award period and relies upon the expenditures reported in the annual two-part consolidated application (CONAPP), the year-end expenditure report. Part II of the CONAPP, which contains the program expenditure data, is due to Education seven months after the end of the fiscal year.

The timing of the payments made to LEAs does not take the LEAs' cash needs into consideration as no expenditure data or input was obtained from the LEAs during the award year. As a result of this condition, Education disbursed over $1.7 billion during the fiscal year ending June 30, 2006 with no assurances that these subrecipients minimized the time between the receipt and disbursement of federal funds, which would not comply with Federal guidelines.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education review its current policies and procedures over the issuance of cash advances to LEAs to more effectively monitor the cash needs of its LEAs with the timing of the payments to minimize the time elapsing between the advance of federal funds and expenditure by the LEAs.

Department's View and Corrective Action Plan:

On May 2, 2006, Education met with the U.S. Department of Education Risk Management Team to discuss cash management with consideration given to Education's existing capabilities and funding processes. However, solutions were deemed to be on a program-by-program basis due to the unique features of individual programs, data collection requirements, and available program resources. Education continues to explore procedural improvements that will reduce the time in which federal funds are distributed to and expended by funding recipients.

Reference Number:	2006-3-6
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants

Federal Award Number and Calendar Year Awarded:	S318X050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over payments made to subrecipients, we noted Education does not have a process in place for assessing the cash needs of its subrecipients. Education requests advance funds from the Federal government and makes two predetermined payment advances to Local Educational Agencies (LEAs) during the fiscal year with the final payment to be made after the receipt of the year-end final expenditure report. Education does not require periodic expenditure reporting or input by the LEAs during the award period but requires the year-end final expenditure report, which is due to Education approximately 60 days after the end of the State fiscal year.

The timing of the payments made to LEAs does not take the LEAs' cash needs into consideration as no expenditure data or input was obtained from the LEAs during the award year. As a result of this condition, Education disbursed over $81 million during the fiscal year ending June 30, 2006 with no assurances that these subrecipients minimized the time between the receipt and disbursement of federal funds, which would not comply with Federal guidelines.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education review its current policies and procedures over the issuance of cash advances to LEAs to more effectively monitor the cash needs of its LEAs with the timing of the payments to minimize the time elapsing between the advance of federal funds and expenditure by the LEAs.

Department's View and Corrective Action Plan:

Education continues to explore improvements to more closely monitor and match the cash needs of LEAs with the timing of the payments to minimize the time elapsing between the LEA's receipt of funds and actual expenditures.

Reference Number:	2006-3-7
Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over payments made to subrecipients, we noted Education does not have a process in place for assessing the cash needs of its subrecipients. Education requests advance funds from the Federal government and makes two predetermined payment advances to Local Educational Agencies (LEAs) during the fiscal year with the final payment to be made after the receipt of the year-end final expenditure report. Education does not require periodic expenditure reporting or input by the LEAs during the award period but requires the year-end final expenditure report, which is due to Education approximately 60 days after the end of the State fiscal year on June 30, 2006. In our sample of 50 LEAs we noted five had to be billed back by Education after the end of the award period for over advanced funds because they had not been fully expended.

The timing of the payments made to LEAs does not take the LEAs' cash needs into consideration as no expenditure data or input was obtained from the LEAs during the award year. As a result of this condition, Education disbursed over $28 million during the fiscal year ending June 30, 2006 with no assurances that these subrecipients minimized the time between the receipt and disbursement of federal funds, which would not comply with Federal guidelines.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education review its current policies and procedures over the issuance of cash advances to LEAs to more effectively monitor the cash needs of its LEAs with the timing of the payments to minimize the time elapsing between the advance of federal funds and expenditure by LEAs.

Department's View and Corrective Action Plan:

On May 2, 2006, Education met with the U.S. Department of Education Risk Management Team to discuss cash management with consideration given to Education's existing capabilities and funding processes. However, solutions were deemed to be on a program-by-program basis due to the unique features of individual programs, data collection requirements, and available program resources. Education continues to explore procedural improvements that will reduce the time in which federal funds are distributed to and expended by funding recipients.

Reference Number:	2006-3-8
Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible

to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over English Language Acquisition payments made to subrecipients, we noted Education's process for assessing the cash needs of its subrecipients consists of comparing the expenditures reported on three periodic reports (i.e., mid-year, 3rd quarter, and year-end) to the previous cash advances made to determine if the Local Educational Agency (LEA) has expended enough of the prior cash advances to warrant another cash advance.

In our sample of 64 LEA advance payment considerations, we noted 10 LEAs that had sufficient expenditures when compared to the advances made but did not receive the scheduled advance. In the same sample, we also noted one LEA was paid a cash advance before it had submitted the required expenditure report to support it had expended the earlier advance.

As a result of these exceptions noted, Education disbursed approximately $152 million during the fiscal year ending June 30, 2006 with no assurances that these subrecipients minimized the time between the receipt and disbursement of federal funds, which would not comply with Federal guidelines.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education strengthen controls over its LEA cash advance process to ensure that Education's policy is being followed consistently and documentation is maintained to justify any deviations from the policy.

Department's View and Corrective Action Plan:

Education will strengthen controls over LEA cash advances to ensure that Education's policy is consistently followed. For example, Education will require a second level approval to: (1) ensure that all required expenditure reports are reviewed, (2) verify that the data reports are accurate, and (3) assess the cash needs of LEAs before subsequent cash advances are released.

Reference Number:	2006-3-9
Federal Catalog Number:	84.367
Federal Program Title:	Improving Teachers Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over Education's payments made to subrecipients, we noted it does not have an adequate process in place for assessing the cash needs of its subrecipients. Education does not require periodic expenditure reporting at different intervals throughout the year but instead utilizes the June 30th year-end expenditures that are reported to it on three different dates on the Consolidated Application (CONAPP) and Standard Account Code Structure (SACS) trial balance general ledger. On the annual two-part CONAPP report Local Educational Agencies (LEAs) report the status of their year-end expenditures. On the first part of the CONAPP, which is due on June 30, 2005, the LEA reports its estimated expenditures to date for the year ended June 30, 2005. The second part of the CONAPP, which is due January 31, 2006, the LEAs report the final expenditures for that same fiscal year ending June 30, 2005. The SACS trial balance is due September 15, 2005 for the same June 30, 2005 expenditures.

Education requests advances from the Federal government and compares the prior year expenditures reported on the three different dates for the prior year-end expenditure reports: CONAPP, Part 1; CONAPP, Part 2; and SACS trial balance, to the prior year cash payments made to the LEA to assess if the LEA warrants another payment. Due to a backlog, the program made only one advance payment to the LEAs in April 2006 for 40% of the total award amount, which was approximately 76% into the award period. Neither the second advance payment of 40% or final payment of 20% has been made to the LEAs as of December 2006.

This payment timing does not take the current year LEAs' cash needs into consideration as the only expenditure data taken into consideration was the prior year. No current year expenditure data was obtained from the LEAs during the award year to monitor and minimize the time elapsing between the expenditure and receipt of program funds. As a result of this condition, Education disbursed approximately $324 million during the fiscal year ending June 30, 2006 with no assurances that subrecipients minimized the time between the receipt and disbursement of federal funds, which would not comply with Federal guidelines.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education review its current policies and procedures over the issuance of cash advances to LEAs to more effectively monitor the cash needs with the timing of the payments to minimize the time elapsing between the advance of federal funds and expenditure by LEAs.

Department's View and Corrective Action Plan:

Education will strengthen current policies and procedures over LEA cash advances to more effectively monitor and more closely match the cash needs of LEAs, and minimize the time between the advance of federal funds and expenditure by the LEA. For example, to effectively assess the cash needs of LEAs, Education will require quarterly expenditure reports from the LEAs.

Reference Number:	2006-3-10
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005

Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S3332A050005; 2005

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005

Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34–EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.21 Payment:

- Interest earned on advances. Except for interest earned on advances of funds exempt under the Intergovernmental Cooperation Act (31 U.S.C. 6501 et seq.) and the Indian Self-Determination Act (23 U.S.C. 450), grantees and subgrantees shall promptly, but at least quarterly, remit interest earned on advances to the Federal agency. The grantee or subgrantee may keep interest amounts up to $100 per year for administrative expenses.

Condition:

Comprehensive School Reform Demonstration: During our procedures performed over cash management of the subrecipients we noted Education did not notify the Local Educational Agencies (LEAs) of the requirement to return interest earned on advances nor did they request this information in their year-end report entitled *Summary of Expenditures for Fiscal year 2005–2006*. We also noted there were no processes or controls in place to collect and return the interest earned over $100 to the federal Department of Education.

Title I Grants to Local Educational Agencies and Improving Teacher Quality State Grants: During our procedures performed over cash management, we noted Education did notify the LEAs of the requirement to return interest earned on advances, however, they did not require the interest earned to be reported on the Consolidated Application (CONAPP) nor are there any processes or controls in place to collect and return the interest earned over $100 to the Federal Department of Education. The current process consists of the LEA voluntarily sending a check to Education, who then forwards those payments to the Federal government. For the fiscal year ending June 30, 2006 only 29 interest payments were received from the LEAs totaling $409,466 for all Education programs. We noted in one subrecipient's A-133 audit report the interest earned on Title I program alone to be $1.8 million during the fiscal year ended June 30, 2005, which was not returned to Education or the Federal government.

Education does not appear to be adequately monitoring the cash management compliance of its subrecipients, in that potential material amounts of interest earned on cash advances paid by Education without an adequate assessment of immediate cash needs, are not being returned. By not implementing appropriately designed processes, controls, and enforcement procedures Education cannot adequately ensure its subrecipients' compliance with cash management requirements.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education establish processes and controls to communicate and obtain this information from the LEAs as well as to collect and return the funds back to the federal government, as applicable.

Department's View and Corrective Action Plan:

Education will review and strengthen its processes for requiring LEAs to report and return to Education interest earned on federal funds in amounts greater than $100. Education will forward the remitted interest to the USDOE. If appropriate, Education will deduct any unremitted reported interest from the grantees' final payments.

Reference Number:	2006-5-5
Federal Catalog Number:	84.367
Federal Program Title:	Improving Teachers Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005
Category of Finding:	Eligibility
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart G—What are the Administrative Responsibilities of the State and Its Subgrantees? Section 76.702 Fiscal control and fund accounting procedures:

A State and a subgrantee shall use fiscal control and fund accounting procedures that insure proper disbursement of and accounting for Federal funds.

Condition:

Education has a formal process for calculating the award entitlements made to its subrecipients, however this calculation is performed by one individual and there is no evidence of the review and approval of the calculation by a supervisor to help ensure the accuracy of the calculations. Absence of segregation of duties and proper reviews and approvals increase the risk that material errors may occur within the entitlement calculations.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance policies and procedures to include evidence of a formal detail review and approval of the entitlement calculations.

Department's View and Corrective Action Plan:

Education will enhance policies and procedures by requiring the second level reviewer to document the review and approval of entitlement amounts by initialing the award calculation documents.

Reference Number:	2006-7-4
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005; S010A040005; 2004

Federal Catalog Number:	84.186
Federal Program Title:	Safe and Drug Free Schools and Communities State Grants
Federal Award Number and Calendar Year Awarded:	Q186A050005; 2005

Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Number and Calendar Year Awarded:	S318X050005; 2005; S318X040005; 2004

Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005; T365A040005; 2004

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005; S367A040005; 2004

Category of Finding:	Level of Effort—Maintenance of Effort
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION—SECONDARY EDUCATION, DEPARTMENT OF EDUCATION, PART 299—GENERAL PROVISIONS—Subpart D—Fiscal Requirements Section 299.5 What maintenance of effort requirements apply to ESEA programs?

- General—An Local Educational Agency (LEA) receiving funds under an applicable program listed in paragraph (b) of this section may receive its full allocation of funds only if the State Educational Agency (SEA) finds that either the combined fiscal effort per student or the aggregate expenditures of State and local funds with respect to the provision of free public education in the LEA for the preceding fiscal year was not less than 90% of the combined fiscal effort per student or the aggregate expenditures for the second preceding fiscal year.

- **Expenditures**:

  (1) In determining an LEAs compliance with paragraph (a) of this section, the SEA shall consider only the LEAs expenditures from State and local funds for free public education. These include expenditures for administration, instruction, attendance and health services, pupil transportation services, operation and maintenance of plant, fixed charges, and net expenditures to cover deficits for food services and student body activities.

  (2) The SEA may not consider the following expenditures in determining an LEAs compliance with the requirements in paragraph (a) of this section:

    - Any expenditures for community services, capital outlay, debt service or supplemental expenses made as a result of a Presidentially declared disaster.

    - Any expenditures made from funds provided by the Federal Government.

Condition:

During our procedures performed over Education's maintenance of effort calculations we noted the following:

1 Expenditures for debt service, principal and interest were included as part of the expense for free public education, but should be omitted in accordance with the Federal Education Code. We also noted that only the equipment replacement portion of capital outlay was being omitted instead of the entire capital outlay, thereby including expenditures for buildings, improvements, and equipment that should also be omitted. Including these expenditures could inadvertently skew the results of the per pupil expenditure comparison in years when large capital purchases are made or new debt is issued.

2 Education was using unadjusted LEA expenditure figures to calculate compliance with the maintenance of effort requirements instead of using the final audited expenditures. Per further inquiry, the LEAs are required to submit their unaudited financial trial balances electronically in the State required format, Standard Account Code Structure (SACS), to Education by September 15th of each year. These SACS trial balances are then used for all LEA financial measurement calculations (e.g., level of effort) performed by Education. The final audited financial statements are submitted in hard copy to Education through the State Controller's Office by December 15th; however, there is not a required follow up submission of the final SACS trial balance to Education. There is no policy or procedure in place to review and reconcile the unaudited SACS trial balance to the final audited financial statement or review of the subsequent year SACS trial balance submission in the following September for any material adjustments to the fund balance for prior year audit adjustments. By using the unaudited figures, there is a risk that material adjustments or omissions may not be adequately reflected and computed in the maintenance of effort calculation.

3 Education prepares the maintenance of effort calculations for its LEAs; however, they are not being timely prepared. Education has not yet finalized its State fiscal year 2005 calculations, which compare the expenditures for the State fiscal years ending June 30, 2003 to June 30, 2004, even though it received the required SACS expenditure data that it used to perform the calculation on or before September 15, 2004. We also noted Education does not have policies or procedures that require Education to send the final calculations to each LEA annually. It only follows up on any LEA maintenance of effort failures. By not timely performing and providing these calculations to its LEAs, Education is not providing information required by its LEAs in completing their annual A-133 audits.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education review its current maintenance of effort calculation to update for any items that are required to be adjusted. We also recommend that Education use the final audited LEA financial figures in performing its maintenance of effort calculations either by modifying the required timing of the SACS submissions or requiring an additional submission. We further recommend Education enhance its current procedures to ensure that timely calculations are completed and communicated to its LEAs to assist in the timely completion of the A-133 audits of both Education and the LEAs.

Department's View and Corrective Action Plan:

Condition 1—Education has reviewed its calculation of the "Current Expense of Education", a statutory calculation, and determined it to be close, but not identical, to the federal definition of expense for free public education (see www.cde.ca.gov/ds/fd/ec/). To calculate the expense for free public education, Education utilizes the automated Standardized Account Code Structure (SACS) and the "Current Expense of Education" per average daily attendance calculation. Since the Current Expense of Education calculation through the SACS automatically excludes capital outlay, debt service, and interest, it is not necessary to make manual adjustments to exclude these costs. However, equipment replacement expenditures are not automatically excluded in the "Current Expense of Education" calculation; accordingly, Education manually excludes these costs to arrive at the expense for free public education.

Condition 2—The LEAs are required to electronically submit unaudited data via the SACS to Education by October 15 of each year. The SACS was developed because of the significant number of LEAs and to electronically obtain data from the even greater number of financial expenditure and revenue accounts. Both the level of detail required to perform the MOE calculations and the number of LEAs dictate that Education utilize electronic data to calculate MOE.

Education receives audit reports by December 15 of each year; however, the audit reports are submitted in hard copy and are not in sufficient detail for Education to perform the required calculations. Using audited data is not feasible unless data is submitted electronically, and current State statute is revised to require that audit reports present expenditures and revenue accounts in the level of detail necessary to perform the MOE calculations.

Condition 3—Since final entitlements are not known until the end of the fiscal year, and adjusting the entitlements mid-year creates significant statewide recalculation problems, in cases of noncompliance, Education adjusts the LEA entitlements the following year. However, Education has

developed new MOE forms for the SACS that will enable the LEAs to better view the calculations and to assess compliance with MOE requirements. Currently, Education is testing the SACS software changes to verify the integrity of data collection and the MOE calculations.

Auditors' Comment on Department's View:

Condition 1—The Auditor's review of the actual calculations performed by Education are not consistent with the definitions indicated in the Department's view. The staff performing the actual calculations indicated Education is not required to exclude expenses related to capital outlay and debt service unless they were incurred as a result of a Presidentially declared disaster, otherwise they should not be excluded.

Condition 2—The Auditor agrees that the SACS data is the most effective means of obtaining the information to perform the required MOE calculations, however Education may consider changing the timing or frequency of the SACS submissions to utilize the final audited numbers instead of the unaudited interim numbers to perform accurate calculations. To revise the State statute to require that audit reports present expenditures and revenue accounts in an expanded level of detail to perform the MOE calculations is not necessary.

Condition 3—Education's statement regarding mid-year adjustments is not applicable to the finding condition. The finding demonstrates that Education had not completed its 2005 calculation even though it received the two prior years of expenditure information needed to perform the calculation by September 2004.

Reference Number:	2006-7-5
Federal Catalog Number:	84.027
Federal Program Title:	Special Education Cluster—Special Education Grants to States
Federal Award Number and Calendar Year Awarded:	H027A030116; 2003; H027A040116; 2004
Category of Finding:	Level of Effort—Maintenance of Effort
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION—REHABILITATIVE SERVICES, DEPARTMENT OF EDUCATION PART 300—ASSISTANCE TO STATES FOR THE EDUCATION OF CHILDREN WITH DISABILITIES—Subpart B—State and Local Eligibility—Section 300.154 Maintenance of State financial support. (a) General:

> The State must have on file with the Secretary information to demonstrate, on either a total or per-capita basis, that the State will not reduce the amount of State financial support for special Education and related services for

> children with disabilities, or otherwise made available because of the excess costs of educating those children, below the amount of that support for the preceding fiscal year.

TITLE 20—EDUCATION—CHAPTER 33—EDUCATION OF INDIVIDUALS WITH DISABILITIES—SUBCHAPTER II—ASSISTANCE FOR EDUCATION OF ALL CHILDREN WITH DISABILITIES—Section 1412. State eligibility (a) In general:

A State is eligible for assistance under this subchapter for a fiscal year if the State submits a plan that provides assurances to the Secretary that the State has in effect policies and procedures to ensure that the State meets each of the following conditions:

> (18) Maintenance of State financial support—(A) In general: The State does not reduce the amount of State financial support for special Education and related services for children with disabilities, or otherwise made available because of the excess costs of educating those children, below the amount of that support for the preceding fiscal year.

Condition:

Consistent with prior year findings, for years 2001–2002 through 2004–2005, Education was unable to obtain clarification with the U.S. Department of Education (USDOE) on which funds should be included in its maintenance of effort determination, thus we cannot conclude whether or not it has met this requirement.

To demonstrate its compliance with this maintenance of effort requirement for fiscal year 2003–04, the most recent year for which complete information is available, Education included 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 2003–04 by $130,496 of the $3.01 billion of expenditures made in 2003–2004. Due to these conditions, we cannot conclude that it has included all of the information to demonstrate its compliance with the requirement. For example, Special Education expenses incurred by other State departments, such as Mental Health expenditures, which were $133 million and $148 million for years 2001–2002 and 2002–2003, respectively, were not included. It has also included the amount of local property taxes required to be allocated for Special Education instead of the actual expenditures made during the fiscal year, where unexpended allocations could cause noncompliance. This clarification of expenditures to be included becomes more notably important with Education's calculation of this requirement being met by only $130,496 or 0.004% for the 2003–2004 fiscal year.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education continue with its ongoing discussions with the USDOE and request written clarification from the USDOE as to what should be included and excluded from the State's maintenance of effort calculation.

Department's View and Corrective Action Plan:

On May 22, 2006, Education sent a letter to the USDOE delineating the components included in Education's calculation of Maintenance of Effort for Special Education; Education awaits USDOE's response.

Reference Number:	2006-7-7
Federal Catalog Number:	84.027
Federal Program Title:	Special Education Cluster—Special Education Grants to States
Federal Award Number and Calendar Year Awarded:	H027A030116; 2003
Category of Finding:	Earmarking—Formula Subgrants to LEAs
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 20—EDUCATION—CHAPTER 33—EDUCATION OF INDIVIDUALS WITH DISABILITIES—SUBCHAPTER II—ASSISTANCE FOR EDUCATION OF ALL CHILDREN WITH DISABILITIES, Section 1411. Authorization; allotment; use of funds; authorization of appropriations, (f) Subgrants to local Educational agencies:

(1) Subgrants required—Each State that receives a grant under this section for any fiscal year shall distribute any funds the State does not reserve under subsection (e) to local Educational agencies (including public charter schools that operate as local Educational agencies) in the State that have established their eligibility under section 1413 of this title for use in accordance with this subchapter.

(2) Procedure for allocations to local Educational agencies, For each fiscal year for which funds are allocated to States under subsection (d), each State shall allocate funds under paragraph (1) as follows:

(A) Base payments—The State shall first award each local Educational agency described in paragraph (1) the amount the local Educational agency would have received under this section for fiscal year 1999, if the State had distributed 75% of its grant for that year under Section 1411(d) of this title as Section 1411(d) was then in effect.

(B) Allocation of remaining funds—After making allocations under subparagraph (A), the State shall:

(i) allocate 85% of any remaining funds to those local Educational agencies on the basis of the relative numbers of children enrolled in public and private elementary schools and secondary schools within the local Educational agency's jurisdiction; and

(ii) allocate 15% of those remaining funds to those local Educational agencies in accordance with their relative numbers of children living in poverty, as determined by the State Educational agency.

Condition:

During our procedures performed over earmarking requirements, we reviewed Table I entitled *Fiscal Year 2003 Allocations Grants to States Individuals with Disabilities Education Act—Part B, Section 611* attached to the Grant Award Document from the Federal Department of Education. We noted it indicated some specific earmarking requirements for each state, including California. In Column B, *Minimum Flow—Through to Local Educational Agencies (LEAs)*, it indicated the amount as $830,013,772, however per review of expenditure data compiled by Education we noted the total expenditures to be only $829,260,041, thus under the requirement of grants to LEAs by $753,731.

Questioned Costs:

$753,731 ($830,013,772 required—$829,260,041 actual expended)

Recommendations:

We recommend that Education strengthen monitoring controls over its earmarking calculations to ensure that they are reviewed at least on an annual basis and make any budget revisions as necessary to comply with the requirement over the 27-month period of availability to comply with required expenditure earmarks.

Department's View and Corrective Action Plan:

Education will strengthen monitoring controls over its earmarking calculations to ensure that they are reviewed on a quarterly basis. Additionally, Education will ensure that the earmark amount is correctly designated on the carryover worksheet by requiring the review and approval of both the Budget Office and Special Education Division.

Reference Number:	2006-8-1
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Number and Calendar Year Awarded:	S318X030005; 2003

Federal Catalog Number:	84.369
Federal Program Title:	Grants for State Assessments and Related Activities
Federal Award Number and Calendar Year Awarded:	S369A030005; 2003

Category of Finding:	Period of Availability
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.23 Period of availability of funds:

- Liquidation of obligations. 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 the program regulation) to coincide with the submission of the annual Financial Status Report (SF-269). The Federal agency may extend this deadline at the request of the grantee.

Condition:

Education Technology—During our procedures performed over the timing of the liquidation payments made during the closeout of the 2003-2004 grant award, we noted 8 of the 20 items sampled and required to be liquidated by December 29, 2005 were paid in January 2006.

Grants for State Assessments—During our procedures performed over the timing of the liquidation payments made during the closeout of the 2003-2004 grant award, we noted 3 of the 7 items sampled and required to be liquidated by December 29, 2005 were paid in January 2006.

Based on review of the batch dates of the check requests made by Education, it appeared that the check requests were made on December 14th and 22nd. Since neither program fell under the Cash Management Improvement Act (CMIA) agreement between the U.S. Department of the Treasury and the State, the payment timing fell under Education's adopted internal policy of checks being issued 14 days from the date the request was made, which cause the payments to be made after the end of the liquidation period. Liquidations of program encumbrances/expenditures made after the period allowable are no longer allowable costs.

Questioned Costs:

$179,024 of the $1,403,877 sampled for the Education Technology Program

$1,435 of the $257,213 sampled for the Grants for State Assessments Program

Recommendations:

We recommend that Education strengthen controls over its grant closeout process to ensure that all program funds are liquidated within the required timeframe.

Department's View and Corrective Action Plan:

Grant funds were available for drawdown in the Grant Administration and Payment System (GAPS) until January 3, 2006. The federal cash was drawn on December 29, 2005, for deposit January 3, 2006. Although the State Controller's Office (SCO) may have made payment on the obligations in January 2006, Education liquidated the obligations on GAPS and submitted the claim schedules to the SCO for payment on December 30, 2005 (prior to the end of the liquidation period). However, Education will work with its program offices in ensuring that program funding obligations continue to be liquidated within the required time periods

Reference Number:	2006-9-2
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005

Federal Catalog Number:	84.027 & 84.173
Federal Program Title:	Special Education Cluster—Special Education Grants to States & Special Education Pre-School Grants
Federal Award Number and Calendar Year Awarded:	H027A050116; 2005, H173A050120; 2005

Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded	S332A050005; 2005

Category of Finding:	Procurement, Suspension and Debarment
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.35 Subawards to debarred and suspended parties:

> Grantees and subgrantees must not make any award or permit any award (subgrant or contract) at any tier to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549, *Debarment and Suspension*.

Condition:

Migrant Education: We reviewed the State of California Standard Agreements made with two program subcontractors and noted that the Agreements did not include any language regarding suspension or debarment. Education has Federal Certifications Forms (Form No. CO. 7 12/02) which contain nonsuspension and debarment certification language, however these certifications were not included with the contracts on file.

Special Education Cluster: The Grant Award Notification document (Award) refers to acceptance of grant conditions and assurances. The grant assurances are contained in an attachment to the Award, however the General Assurances and Federal Funds Conditions are indicated as an

“attachment” but no longer attached to the Grant Award document. Education stated that this General Assurances and Federal Funds Conditions attachment is available on Education’s website, however there is no specific website address given on the Award as to where to locate these assurances. In searching Education’s website we located a page of the website entitled Funding Forms that contained four separate assurance components. The General Assurances and Lobbying, Drug Free Workplace and Suspension and Debarment. All but the General Assurances required a separate signature certification, however Education no longer requires its participating Special Education Local Plan Area (SELPA) or LEAs to sign them and return them as a condition of receiving a grant award. Education expects the SELPAs and LEAs to locate these assurances and keep signed copies on file at the SELPA or LEA. We also noted Education did not verify the nonsuspension or debarment of the LEA on the Excluded Parties List System (EPLS).

Comprehensive School Reform Demonstration: We reviewed the conditions of the grant award and noted that it did not include any language regarding suspension or debarment. Education does have nonsuspension and debarment certification forms available on its website but did not require its participating LEAs to sign them and return them as a condition of receiving a grant award. We also noted Education did not verify the nonsuspension or debarment of the LEA on EPLS.

By not obtaining signed self-certifications of nonsuspension or debarment and not performing any independent checks on the EPLS website, Education is not in compliance with Federal suspension and debarment requirements and runs the risk that it will enter into an agreement with a suspended or debarred LEA or contractor, which would result in all expenditures paid under that agreement being disallowed.

Questioned Costs:

Not applicable

Recommendations:

We recommend Education require a signed certification of nonsuspension or debarment as part of its award approval process. We also recommend that Education implement polices and procedures to include a verification of the EPLS website (www.epls.gov) for all subawards or contracts either on an individual program level or on an Education-wide level to reduce the risk that subawards or contracts will be made to suspended or debarred parties.

Department’s View and Corrective Action Plan:

Education will compare the EPLS website to the California State Accounting and Reporting System (CALSTARS) vendor file used for all payments to verify that an LEA or contractor is not federally suspended or debarred; verification will be documented accordingly. This comparison will be a documented process for the year-end schedule.

Reference Number:	2006-9-4
Federal Catalog Number:	84.369
Federal Program Title:	Grants for State Assessments and Other Activities
Federal Award Number and Calendar Year Awarded:	S369A050005; 2005

Category of Finding:	Procurement, Suspension and Debarment
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart G—What are the Administrative Responsibilities of the State and Its Subgrantees?, Section 76.702 Fiscal control and fund accounting procedures:

A State and a subgrantee shall use fiscal control and fund accounting procedures that insure proper disbursement of and accounting for Federal funds.

Condition:

During procedures performed over Education's procurement process we noted Education has a formal procurement process that includes formal signoffs of contracts paid from Federal program funds. In our sample of 13 contracts for the program, we noted two did not contain all of the required authorized signatures. For the two exceptions, we noted that the signature of the Deputy, Deputy Superintendent, or Chief Legal Counsel was not evidenced on Education's CO-201 Contract Request Form as required by its policies. By not retaining the evidence of review and approval of material program contracts, Education cannot demonstrate that appropriate approvals are in place.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen controls to ensure that all required signatures are obtained during the contract approval process.

Department's View and Corrective Action Plan:

The contracts reviewed were processed under the "Contract Worksheet" (old CO-201) process which did not have the tighter signature controls the Contracts Office now has in place with the "Contract Request Form" (new CO-201) process. In response to the finding, the Contracts Office has already strengthened its controls to ensure that all required signatures are obtained during the CO-201 routing process.

Reference Number:	2006-12-5
Federal Catalog Number:	84.027 & 84.173
Federal Program Title:	Special Education Cluster—Special Education Grants to States & Special Education PreSchool Grants

Federal Award Number and Calendar Year Awarded:	H027A050116; 2005, H173A050120; 2005
Category of Finding:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, REHABILITATIVE SERVICES, DEPARTMENT OF EDUCATION, PART 300—ASSISTANCE TO STATES FOR THE EDUCATION OF CHILDREN WITH DISABILITIES—Subpart G—Allocation of Funds; Reports, Section 300.754 Annual report of children served—other responsibilities of the SEA. In addition to meeting the other requirements of Section 300.750—300.753, the SEA shall:

(e) Ensure that documentation is maintained that enables the State and the Secretary to audit the accuracy of the count.

Condition:

During procedures performed over special reporting for the *Report of Children and Youth with Disabilities Receiving Special Education Under Part B of the Individuals With Disabilities Education Act*, as amended (OMB No. 1820-0043), we reviewed the controls built into Education's California Special Education Management Information System (CASEMIS) software program which is used to compile data used for this report. We noted that CASEMIS contained built-in edit checks to identify errors or any potentially duplicate participants, however there is no ability to evidence that each edit check is successfully performed or other audit trail to show successful completion of all edit checks. We also noted there was inadequate evidence of control totals to ensure that there were no duplicate students contained in the CASEMIS system. The absence of evidence of system controls being performed effectively increases the risk of inaccurate reporting.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current CASEMIS system controls to provide for audit trails or other evidence to support that all edit checks are cleared and add control totals to reduce the risk of potential inaccuracies in the reporting of the unduplicated student count.

Department's View and Corrective Action Plan:

Education will create the appropriate audit trails in its CASEMIS procedures and software documenting that edit checks are successfully performed. Additionally, Education will enhance current procedures to include control totals to reduce the risk of potential material inaccuracies in reporting the unduplicated student count.

Reference Number:	2006-12-6
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:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart G—What are the Administrative Responsibilities of the State and Its Subgrantees?, Section 76.731 Records related to compliance.

- A State and a subgrantee shall keep records to show its compliance with program requirements.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and

- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.42 Retention and access requirements for records:

- Length of retention period—except as otherwise provided, records must be retained for three years from the starting date.

- Starting date of retention period—when grant support is continued or renewed at annual or other intervals, the retention period for the records of each funding period starts on the day the grantee or subgrantee submits to the awarding agency its single or last expenditure report for that period.

Condition:

During procedures performed over reporting, we selected 25 items of data reported on Education's annual Consolidated State Performance Report for Funding Year 2004–05, which was submitted during 2006, and requested supporting documentation for those items. Education did not maintain copies of the documentation used to prepare the report and was unable to provide supporting documentation for all 25 of the items sampled, which related to participant population data, academic status, participation, school data, and project data for the Migrant Education Program. By not maintaining documentation to support required reporting, Education is not in compliance with Federal reporting requirements.

The Consolidated State Performance Report approval process includes a top level review and approval from an Education department official of the data that is compiled by a subcontractor; however, there was no documented evidence of this review. We also noted there was no evidence of the review and approval from an Education department official of the data that is compiled by a subcontractor for the Migrant Child Count Report. The absence of appropriate reviews and approvals of the compilation of required reporting increases the risk of inaccuracies going undetected.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current policies and procedures to include a detailed review be performed and evidenced as part of its reporting approval process to reduce the risk of material inaccurate reporting and to maintain all supporting documentation for required reporting for the required document retention period.

Department's View and Corrective Action Plan:

Education will implement policies and procedures that specify a reporting approval process that involves a detailed review and maintenance of supporting documentation for the required retention period.

This reporting approval process will include documentation to support:

- Quarterly vendor meetings to review LEA data and required NCLB reports, and to discuss and/or correct problems or discrepancies.
- Data accuracy comparisons between the Consolidated State Performance Report (CSPR) and child count reports using current and prior year reports, and LEA data versus vendor reports.
- Annual onsite monitoring and a formal re-interview process for validating child eligibility for child count purposes.

Reference Number:	2006-12-7
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants

Federal Award Number and Calendar Year Awarded:	S318X030005; 2003
Category of Finding:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 76—STATE-ADMINISTERED PROGRAMS—Subpart G—What are the Administrative Responsibilities of the State and Its Subgrantees?, Section 76.731 Records related to compliance.

- A State and a subgrantee shall keep records to show its compliance with program requirements.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—SUBPART C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and

- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.42 Retention and access requirements for records:

- Length of retention period—except as otherwise provided, records must be retained for three years from the starting date.

- Starting date of retention period—when grant support is continued or renewed at annual or other intervals, the retention period for the records of each funding period starts on the day the grantee or subgrantee submits to the awarding agency its single or last expenditure report for that period.

Condition:

During procedures performed over reporting we selected 42 items of data reported on Education's annual Consolidated State Performance Report for Funding Year 2003, which was submitted during 2006, and traced those items to supporting documentation. In our 42 items sampled, we noted Education was unable to provide supporting documentation for two of the items reported. Education did not maintain the original documentation used to create this report but was able to recreate the documentation to support the information reported for all but two items. The two unsupported items related to performance data relating to the percent of teachers qualified to use technology and receiving professional development funds. By not maintaining documentation to support required reporting, Education is not in compliance with Federal reporting requirements.

The reporting approval process includes a top level review and approval from a department official, but it appears there was no documented evidence of this review. The absence of appropriate reviews and approvals of the compilation of required reporting increases the risk of inaccuracies going undetected.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current policies and procedures to include a detailed review be performed and evidenced as part of its reporting approval process to reduce the risk of inaccurate reporting and to maintain all supporting documentation for required reporting for the required document retention period.

Department's View and Corrective Action Plan:

Education will enhance policies and procedures by requiring the second level reviewer to document the review and approval of the data on Education's annual Consolidated State Performance Reports by initialing the report. Additionally, Education will maintain documentation for the required retention period.

Reference Number:	2006-12-8
Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2006
Category of Finding:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and
- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

Condition:

During procedures performed over reporting we selected 25 items of data reported on Education's annual Consolidated State Performance Report and the Comprehensive School Reform Demonstration Program 2005 Evaluation Report and traced those items to supporting documentation. In our 25 items sampled, we noted three did not match the supporting documentation for the reported item. The three inaccuracies related to the subgrant award totals and the number of schools awarded. The reporting approval process includes a top level review and approval from a department official, but it appears there was no detailed level review of tracing the report data to the supporting documentation. Although these differences appeared to be immaterial in the current year reports, differences in future years could be material without a performed detail review.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current policies and procedures to include a detailed review be performed and evidenced as part of its reporting approval process to reduce the risk of material inaccurate reporting.

Department's View and Corrective Action Plan:

Education will enhance policies and procedures requiring a detailed level of review tracing the report data to the supporting documentation. Additionally, documentation of secondary review and approval will be incorporated in the reporting approval process.

Reference Number:	2006-12-9
Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A030005; 2003
Category of Finding:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.20 Standards for financial management systems:

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and

- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.42 Retention and access requirements for records:

- Length of retention period—except as otherwise provided, records must be retained for three years from the starting date.

- Starting date of retention period—when grant support is continued or renewed at annual or other intervals, the retention period for the records of each funding period starts on the day the grantee or subgrantee submits to the awarding agency its single or last expenditure report for that period.

Condition:

During procedures performed over reporting, we selected 50 items of data reported on Education's annual Consolidated State Performance Report (CSPR) for Funding Year 2004-05, which was submitted during 2006, and requested supporting documentation for those items. We noted the department did not maintain the original documentation used to create this report but was able to recreate the documentation to support the information reported for 3 of the 50 items. One of the 47 items sampled that was unsupported was the total number of participating students identified as Limited English Proficiency (LEP). The reported number on the 2004-05 CSPR was 11,581,178, however the same line item on the 2003-04 CSPR was only 1,554,172. Since the total students assessed was only 1,736,931 and the total enrollment population is only 6,322,141, the 11,581,178 reported would not appear reasonable.

The reporting approval process includes a top level review and approval from an Education department official of the data that is compiled by a subcontractor, but there was no documented evidence of this review. The absence of appropriate reviews and approvals of the compilation of required reporting increases the risk of material inaccuracies going undetected.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current policies and procedures to include that a detailed review be performed and evidenced as part of its reporting approval process to reduce the risk of material inaccurate reporting and to maintain all supporting documentation for required reporting for the required document retention period.

Department's View and Corrective Action Plan:

Although Education does not maintain hard copies of all data collected, data is maintained electronically for the required retention periods. However, as part of the review process, Education will enhance procedures by requiring documentation of secondary review and approval. Also, Education will maintain hard copies of data supporting the Consolidated State Performance Report.

Reference Number:	2006-13-4
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education (Education)

Criteria:

Office of Management and Budget (OMB) Circular A-133: *Audits of States, Local Governments, and Non-Profit Organizations*, Subpart D—Federal Agencies and Pass-Through Entities, Section 400 Responsibilities, (d) Pass-through entity responsibilities: A pass-through entity shall perform the following for the Federal awards it makes:

- Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.

- Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.37 Subgrants: States shall follow state law and procedures when awarding and administering subgrants of financial assistance to local and Indian tribal governments. States shall:

- Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations;

- Ensure that subgrantees are aware of requirements imposed upon them by Federal statute and regulation;

- Ensure that a provision for compliance with 80.42 (retention and access requirements for records) is placed in every cost reimbursement subgrant; and

- 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.

Condition:

During our procedures performed over award identification we were unable to identify any controls to ensure that award information was properly identified to the Local Educational Agencies (LEAs). We noted the *Grant Award Notification* (Form AO-400) did not contain the name of the Federal agency. We also noted in the Standard Account Code Structure (SACS) program identification information that Education indicated approximately $5 million of the $108 million accrued basis expenditures of these program funds, which were part of the Even Start portion of the program, as CFDA number 84.214 instead of 84.011. This incorrect program identification information would cause subrecipients to follow incorrect program regulations.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen controls over award identification to ensure that all required award information is properly communicated to the LEAs as required.

Department's View and Corrective Action Plan:

Education has strengthened controls over award identification to ensure that all required award information is properly communicated to the LEAs. For example, Education revised the Grant Award Notification form to include the CFDA number, name of the federal agency, and CFR references. Additionally, current policy requires that information about the federal program be included in the Request for Application documents. Applicants must review this information and sign an application form to be considered for a grant.

Reference Number:	2006-13-5
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005

Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants

Federal Award Number and Calendar Year Awarded:	S318X050005; 2005

Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005

Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005

Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.12 Special grant or subgrant conditions for 'high-risk' grantees:

(a) A grantee or subgrantee may be considered "high risk" if an awarding agency determines that a grantee or subgrantee:

- Has a history of unsatisfactory performance, or
- Is not financially stable, or
- Has a management system which does not meet the management standards set forth in this part, or
- Has not conformed to terms and conditions of previous awards, or
- Is otherwise not responsible; and if the awarding agency determines that an award will be made, special conditions and/or restrictions shall correspond to the high risk condition and shall be included in the award.

(b) Special conditions or restrictions may include:

- Payment on a reimbursement basis;
- Withholding authority to proceed to the next phase until receipt of evidence of acceptable performance within a given funding period;
- Requiring additional, more detailed financial reports;
- Additional project monitoring;
- Requiring the grantee or subgrantee to obtain technical or management assistance; or
- Establishing additional prior approvals.

(c) If an awarding agency decides to impose such conditions, the awarding official will notify the grantee or subgrantee as early as possible, in writing, of:

- The nature of the special conditions/restrictions;
- The reason(s) for imposing them;
- The corrective actions which must be taken before they will be removed and the time allowed for completing the corrective actions and
- The method of requesting reconsideration of the conditions/restrictions imposed.

Condition:

During inquiries made with program specific personnel and the central Education Management Assistance, Categorical Programs and Audit Resolution Unit, we were unable to obtain or identify any policies or procedures for assessing Local Educational Agencies (LEAs) subrecipients as high risk either on the individual program level or on the overall LEA level. Identification of higher risk LEAs is a critical component in determining the extent of during-the-award monitoring procedures to be performed.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education develop formal policies and procedures to determine whether any LEAs should be considered as high risk. These assessments should be made in cooperation with various Education departments (consolidated program monitoring, audit resolution, program, etc.) to obtain sufficient knowledge to make an informed assessment of the LEAs' performance. Any LEAs assessed as high risk should have this information communicated to the LEA as well as disseminated among the various Education departments to assist in development of appropriate monitoring during the award period.

Department's View and Corrective Action Plan:

Education will develop policies and procedures to obtain sufficient knowledge in making informed assessments of LEAs' performance on a program-specific basis. To assist in this process, Education will disseminate summary reports of A-133 audit findings to program staff.

Reference Number:	2006-13-6
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005
Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005
Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

- Require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.40 Monitoring and reporting program performance, (a) Monitoring by grantees:

- Grantees are responsible for managing the day-to-day operations of the grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

During procedures performed over subrecipient monitoring, we noted the program is monitored by the Consolidated Program Monitoring (CPM) Unit of Education. This unit performs program monitoring site reviews on its subrecipients, where Education selects a subrecipient and monitors a number of its larger programs. We selected a sample of schools that had been monitored and reviewed the documentation retained to support the review's findings and conclusions and noted the following:

- Documentation of the monitoring visit is evidenced by the *Cross-Program Instrument* (CP). This *CP* is the only official documentation that is retained to support the procedures performed during the monitoring visit. The CPM does not retain detail work paper documentation of the samples tested, interviews performed, etc., to support the conclusions reached.

- The monitoring procedures contained limited fiscal procedures and should be enhanced to cover all major functions and activities of the program.

- There was no documented signoff of approval for the procedures performed and conclusions reached for the monitoring visit on the CP by someone other than the preparer.

By not maintaining adequate documentation of the procedures performed or ensuring that appropriate reviews and approvals are performed, Education is not able to adequately support conclusions reached during its monitoring visits.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over subrecipient monitoring, specifically the during-the-award monitoring (i.e., monitoring visits), to ensure sufficient documentation is retained in enough detail to support the conclusions reached and that there is evidence this documentation is reviewed by someone other than the preparer before final reports are issued.

We also recommend that Education enhance the extent of the monitoring procedures performed or documentation maintained to support tests of fiscal elements (i.e., sampling expenditures from the general ledger to test for allowability, tests of documentation to support private school per pupil allocations, samples tested to support supplement not supplant, etc.) to support they are being adequately reviewed and to ensure that these monitoring procedures cover each program, function and activity of the Local Educational Agencies (LEAs) that is sampled. This additional documentation of procedures will support Education's assertions that its subrecipients are complying with program laws, regulations and grant award provisions and that its performance goals and objectives are being achieved.

Department's View and Corrective Action Plan:

Education will strengthen procedures over subrecipient monitoring by requiring reviewers to notate in more detail the documents or evidence used to support the conclusions on the site visitation form. Also, Education will require a secondary reviewer to initial the site visitation forms to indicate approval. With regard to testing fiscal elements, Education follows up on information reported by the LEA's independent certified public accountant's A-133 single audit reports. Additionally, Education follows up on any fiscal concerns identified in other subrecipient monitoring reviews (e.g., categorical program monitoring and contract monitoring reviews). If more extensive fiscal procedures are deemed necessary, Education's Audits and Investigations Division can be requested to assist in determining an LEA's compliance with required fiscal elements.

Auditors' Comment on Department's View and Corrective Action Plan:

The Auditor believes that Education's view of placing significant reliance on subrecipient A-133 audits does not adequately address the risk of material noncompliance of all programmatic and fiscal requirements by its LEAs. Education should consider the complexity of the requirements and the risk that LEAs may not assess compliance correctly. Education, as a pass through entity, is responsible to provide technical advice to the LEAs and auditors of those LEAs, testing key fiscal elements is a valuable tool to assess the understanding of those requirements. Information obtained during its sampled LEAs monitoring visits can then be used to develop more effective guidance to LEAs to assist in complying with required rules and regulations.

Its comment regarding following up on fiscal concerns identified in other monitoring reviews is not applicable, since the condition of the finding indicates the inadequacy of those specific monitoring review procedures that Education indicated where it would follow up.

Reference Number:	2006-13-7
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants

Federal Award Number and Calendar Year Awarded:	S318X050005; 2005
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;
- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;
- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and
- Require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.40 Monitoring and reporting program performance, (a) Monitoring by grantees:

- Grantees are responsible for managing the day-to-day operations of the grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

During procedures performed over subrecipient monitoring, we noted the program has formal monitoring procedures in place, however they include very limited procedures over fiscal requirements. A sample of Local Educational Agencies (LEAs) awards are monitored each year which are selected through a judgmental risk assessment. A total of nine LEAs were monitored during the fiscal year. Documentation of the monitoring visit is evidenced by the *Enhancing Education Through Technology Site Visitation Form (Form)*. There was no documented signoff of approval for the procedures performed and conclusions reached for the monitoring visit on the Form by someone other than the preparer. This Form is the only documentation that is retained to support the monitoring visit. The program does not retain detail work paper documentation of the samples tested, interviews performed, etc., to support the conclusions reached. We also noted the monitoring visit exit correspondence indicates that the site visit was not an audit and that fiscal certification criteria would be assessed during the annual district audit or by appropriate oversight

agencies, thus reliance is placed on A-133 subrecipient audits and any Federal Agency audits to ensure compliance with fiscal requirements. By not performing monitoring procedures over fiscal requirements, Education risks material noncompliance of subrecipients going undetected on a timely basis.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education strengthen its current policies and procedures over subrecipient monitoring, specifically during-the-award monitoring (i.e., monitoring visits), to ensure that sufficient documentation is retained in enough detail to support the conclusions reached and that there is evidence that this documentation is reviewed by someone other than the preparer before final reports are issued. We also recommend that Education enhance the extent of the monitoring procedures performed or documentation maintained to support tests of fiscal elements (i.e., sampling expenditures from the general ledger to test for allowability, tests of documentation to support private school per pupil allocations, samples tested to support supplement not supplant, etc.) to support they are being adequately reviewed and to ensure that these monitoring procedures cover each program, function, and activity of the LEA that is sampled. This additional documentation of procedures will support Education's assertions that its subrecipients are complying with program laws, regulations, and grant award provisions and that its performance goals and objectives are being achieved.

Department's View and Corrective Action Plan:

Education will strengthen policies and procedures over subrecipient monitoring by requiring reviewers to notate the documents or evidence used to support the conclusions on the site visitation form. Also, Education will require a secondary reviewer to initial the site visitation forms to indicate approval before final reports are issued. In regards to testing fiscal elements, Education follows up on information reported by the LEA's independent certified public accountant's Single Audit Reports. Additionally, Education follows up on any fiscal concerns identified in subrecipient monitoring reviews.

Auditors' Comment on Department's View and Corrective Action Plan:

The Auditor believes that Education's view of placing significant reliance on subrecipient A-133 audits does not adequately address the risk of material noncompliance of all programmatic and fiscal requirements by its LEAs. Education should consider the complexity of some of the requirements and the risk that LEAs may not assess compliance correctly. Education, as a pass-through entity is responsible to provide technical advice to the LEAs and auditors of those LEAs, testing key fiscal elements is a valuable tool to assess the understanding of those requirements. Information obtained during its sampled LEAs monitoring visits can then be used to develop more effective guidance to LEAs to assist in complying with required rules and regulations.

Its comment regarding following up on fiscal concerns identified in other monitoring reviews is not applicable, since the condition of the finding indicates the inadequacy of those specific monitoring review procedures that Education indicated where it would follow up.

Reference Number:	2006-13-8
Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements,

Section 80.37 Subgrants: States shall follow state law and procedures when awarding and administering subgrants of financial assistance to local and Indian tribal governments. States shall:

- Ensure that every subgrant includes any clauses required by Federal statute and executive orders and their implementing regulations;
- Ensure that subgrantees are aware of requirements imposed upon them by Federal statute and regulation;
- Ensure that a provision for compliance with Section 80.42 (retention and access requirements for records) is placed in every cost reimbursement subgrant; and
- Confirm any advances of grant funds to subgrantees substantially to the same standards of timing and amount that apply to cash advances by Federal agencies.

Section 80.40 Monitoring and reporting program performance, (a) Monitoring by grantees:

- Grantees are responsible for managing the day-to-day operations of the grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;
- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

- Require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

Condition:

During our procedures performed over award identification we were unable to identify controls to ensure that award information was properly identified to the Local Educational Agencies (LEAs). We noted the *Grant Award Notification* (Form AO-400) did not contain any of the following: CFDA number, name of federal agency or CFR references for requirements imposed by laws, regulations or provisions. We also noted in the Standard Account Code Structure (SACS) program identification information that Education indicated these program funds as CFDA number 84.010 instead of 84.332. This incorrect program identification information would cause subrecipients to follow incorrect program regulations.

We also noted that the program did not perform comprehensive monitoring of its subrecipients' activities to assess if they were in compliance with the laws, regulations and provisions of grant award agreements or if its performance goals were being achieved. Since 100% of CSR program funds are passed through to subrecipients, there is an increased need for strong subrecipient monitoring procedures to reduce the risk of potential material noncompliance. The program did not perform any site visits or limited scope audits nor was this program part of Education's consolidated program monitoring reviews performed on its subgrantees, where Education selects a subrecipient and monitors a number of its larger programs. The program also did not require its subrecipients to provide annual programmatic reporting in the fiscal year ending June 30, 2006 to assess if the subrecipients had met its goals and objectives, however it did require the submission of one annual financial expenditure report which was reviewed before the final payment was made to the subrecipients. By not performing comprehensive monitoring procedures, Education risks material noncompliance of its subrecipients going undetected.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over subrecipient monitoring, specifically the during-the-award monitoring (i.e., performance reports, site visits, etc.), to ensure that its subrecipients are complying with program laws, regulations, and grant award provisions and that its performance goals and objectives are being achieved. We also recommend that Education ensure that all required award information is properly communicated to the LEAs as required.

Department's View and Corrective Action Plan:

Education has an ongoing annual program evaluation report requirement that, combined with annual review of state performance data, ensures that performance goals are being achieved. However, to strengthen award monitoring procedures, Education's Grant Award Notification forms include the CFDA number. Additionally, to ensure that all required award information is properly communicated to LEAs, Education requires that Federal program information, such as the Federal

agency name and CFR references, be included in the Request for Application (RFA) documents. Applicants must review and sign the RFAs to indicate acknowledgement and agreement to comply with all applicable laws, regulations, and award provisions.

Auditors' Comment on Department's View:

The corrective action plan proposed by management only addresses the award notification element of the finding. It does not include any during-the-award monitoring elements to ensure that all performance goals and objectives are being met.

Reference Number:	2006-13-9
Federal Catalog Number:	84.027 & 84.173
Federal Program Title	Special Education Cluster—Special Education Grants: to States & Special Education PreSchool Grants
Federal Award Number and Calendar Year Awarded:	H027A050116; 2005, H173A050120; 2005
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;
- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;
- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and
- Require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

TITLE 34—EDUCATION, PART 80—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 80.40 Monitoring and reporting program performance, (a) Monitoring by grantees:

- Grantees are responsible for managing the day-to-day operations of the grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to ensure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

During procedures performed over subrecipient monitoring, we noted Education's Focused Monitoring and Technical Assistance Unit (FMTA) conducts site visits of its Local Educational Agencies (LEAs) and Special Education Local Plan Areas (SELPA's). Of the 18 LEAs and SELPA's that were monitored by the FMTA for the fiscal year June 30, 2005, we noted 5 of the 18, which had Education report dates in July, August and October 2005 that contained findings that remained unresolved in December 2006. Of the five LEAs with unresolved findings, four had recent follow up made between September and November 2006, however were still unresolved with the fifth having original report date of August 29, 2005 and no recent follow up. By not performing timely follow up on monitoring visit findings of noncompliance with program regulations, the period of noncompliance for subrecipients is extended causing noncompliance in subsequent grant periods.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over subrecipient monitoring, specifically the during-the-award monitoring (i.e., monitoring visits), to ensure that timely follow up is performed to ensure corrective action on deficiencies noted in during-the-award monitoring.

Department's View and Corrective Action Plan:

Education will strengthen policies and procedures over monitoring visits by documenting the corrective actions taken by subrecipients on reported deficiencies and the status of any unresolved deficiencies. Additionally, Education will reiterate to SELPA directors that all corrective action on reported deficiencies must be completed within one year.

Reference Number:	2006-13-10
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005

Federal Catalog Number:	84.027 & 84.173
Federal Program Title:	Special Education Cluster—Special Education Grants to States & Special Education Pre-School Grants
Federal Award Number and Calendar Year Awarded:	H027A050116; 2005, H173A050120; 2005

Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Number and Calendar Year Awarded:	S318X050005; 2005

Federal Catalog Number:	84.332
Federal Program Title:	Comprehensive School Reform Demonstration
Federal Award Number and Calendar Year Awarded:	S332A050005; 2005

Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A050005; 2005

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A050005; 2005

Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity.

Condition:

During procedures performed over subrecipient monitoring, we noted that the A-133 audits of the subrecipient Local Educational Agencies (LEAs) are initially collected by the State Controller's Office who ensures the completeness and timeliness of all LEA reports. The LEA reports are simultaneously sent to Education to address the findings and recommendations noted. Education maintains a central department entitled Management Assistance, Categorical Programs, and Audit Resolution that is responsible for addressing and resolving findings noted in the A-133 reports. The data from these reports is entered into a central database to track the status of findings and recommendations.

- Education relies upon this database as its sole tracking device for subrecipent audit findings that need to be addressed by Education. There does not appear to be adequate segregation of duties or an independent review process by the consultants who are responsible for the database. The A-133 reports are input into the database by the consultants; however the review of the data input is checked by the same consultant who performed the input. There is no independent review of the database information by the department administrator to assess its accuracy or completeness.

- There is no formal report generated from the database to be reviewed by Education management that summarizes the status of LEA findings that are required to have Education management decisions issued within six months after receipt of the report. This information is needed by management to adequately monitor the audit finding resolution process being performed by its consultants to ensure timeliness of the management decisions required to be made. Of the 50 June 30, 2005 A-133 LEA reports sampled, we noted 12 LEAs with audit findings that required Education management decisions. Of those 12 LEAs requiring management decisions, we noted two with unresolved findings outstanding after 10 months and two additional LEAs with findings resolved later than six months after the receipt of the report.

- Findings are resolved with the LEAs by the consultants in the Management Assistance, Categorical Programs, and Audit Resolution Unit. We noted some informal e-mail communications discussing some of the findings contained in the reports, however there is no formal notification from the Audit Resolution Department to the respective Education program departments or Consolidated Performance Monitoring Unit nor are copies of any audit resolution correspondence forwarded to the respective program department regarding the A-133 audit findings of its subrecipients. This information is important to the program departments to assist in the development of their monitoring procedures to be performed over its program subrecipients. With this information the program department could more accurately determine subrecipient risk and focus its monitoring efforts on higher risk LEAs that either had audit findings or did not have its program audited as a major program in the last year or last several years.

Without appropriately designed segregation of duties and formal checks, balances and communications, Education risks noncompliance noted in Subrecipient A-133 audits are not being timely addressed and resolved to comply with Federal regulations.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over its A-133 audit finding resolution process by formalizing communications and resolutions. The files should contain formal evidence of input, reviews and approvals that supports the timing, agreement with the proposed corrective action, and notification of the respective program department.

We also recommend that Education generate a periodic status of findings and corrective actions for review by the audit resolution department administrator to assist in monitoring the timeliness of Education's resolution of audit findings.

We further recommend that Education disseminate the information obtained from the A-133 reports captured in the database (i.e., number of LEAs with Education Technology audited as a major program, identification of findings for Education Technology program, etc.) to the appropriate program staff and consolidated program monitoring unit to assist in the determination of subrecipient risk, which is an important component of determining the extent of the during-the-award monitoring procedures that should be performed on specific LEAs.

Department's View and Corrective Action Plan:

To assist in monitoring the timeliness of an LEA's resolution of audit findings, Education will disseminate a summary report of A-133 audit findings to respective program staff. Additionally, Education will provide a status report of A-133 audit findings to the administrator of the Audit Resolution Unit for review, approval, and to manage the resolution of A-133 audit findings.

Reference Number:	2006-14-3
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005
Category of Finding:	Special Tests and Provisions—Comparability
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 20—EDUCATION, CHAPTER 70—STRENGTHENING AND IMPROVEMENT OF ELEMENTARY AND SECONDARY SCHOOLS, SUBCHAPTER I—IMPROVING THE ACADEMIC ACHIEVEMENT OF THE DISADVANTAGED, Part A—Improving Basic Programs Operated by Local Educational Agencies, Subpart 1—basic program requirements, Section 6321. Fiscal requirements, (c) Comparability of services

Procedures and records—Each local educational agency assisted under this part shall:

a. Develop procedures for compliance with this subsection; and

b. Maintain records that are updated biennially documenting such agency's compliance with this subsection.

Condition:

During our procedures performed over comparability, we noted Education has developed specific policies and procedures to assess Local Educational Agencies (LEAs) for compliance with Title I comparability during the fiscal year ended June 30, 2006, which includes a Comparability Report that performs required calculations (e.g., student/teacher ratio, etc.). Any calculations that do not meet the mandated criteria are followed up by Education by requesting revised or supplemental information, however it did not require any documentation to support this revised or supplemental information submitted. We also noted there are no procedures included in the consolidated program monitoring that include any procedures performed to assess the accuracy of data used in the comparability calculations. Without appropriately designed controls to ensure the accuracy of the data utilized for comparability calculations, Education risks that materially inaccurate assessments may be made of comparability requirements of its LEAs.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance current policies and procedures to require LEAs to provide supporting documentation when submitting revised or supplemental data to support compliance with comparability requirements. We also recommend that Education add a procedure in its consolidated program monitoring related to comparability compliance.

Department's View and Corrective Action Plan:

The Categorical Program Monitoring (CPM) Cross-Program, Title I Part A Basic and EIA/SCE, and Program Improvement instruments contain monitoring items for Title I, Part A. The items in these instruments will be reviewed for the monitoring of 20 USC 6321(c), fiscal requirements for comparability of services in coordination and collaboration with all offices involved in the current Comparability Report. If necessary, either a new item or the augmentation of an existing item will take place for inclusion in the 2007–08 CPM cycle. This will be accomplished by April 16, 2007.

Reference Number:	2006-14-4
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A050005; 2005
Category of Finding:	Special Tests and Provisions—Identifying Schools and Local Educational Agencies (LEAs) Needing Improvement
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 20—EDUCATION, CHAPTER 70—STRENGTHENING AND IMPROVEMENT OF ELEMENTARY AND SECONDARY SCHOOLS, SUBCHAPTER I—IMPROVING THE ACADEMIC ACHIEVEMENT OF THE DISADVANTAGED, Part A—Improving Basic Programs Operated by Local Educational Agencies, subpart 1—basic program requirements, Section 6311. state plans, (a) plans required

- Use of assessments—Each State educational agency may incorporate the data from the assessments under this paragraph into a State-developed longitudinal data system that links student test scores, length of enrollment, and graduation records over time.

- Requirements—Such assessments shall:

  – be the same academic assessments used to measure the achievement of all children;

  – be aligned with the State's challenging academic content and student academic achievement standards, and provide coherent information about student attainment of such standards;

  – be used for purposes for which such assessments are valid and reliable, and be consistent with relevant, nationally recognized professional and technical standards;

  – be used only if the State educational agency provides to the Secretary evidence from the test publisher or other relevant sources that the assessments used are of adequate technical quality for each purpose required under this chapter and are consistent with the requirements of this section, and such evidence is made public by the Secretary upon request.

Condition:

During our procedures performed over Identifying Schools and LEAs Needing Improvement, we noted Education has two separate computer systems to compile the data used to assess compliance with this requirement. The source data input into these two programs is extracted from the three Education standardized testing programs: Standardized Testing and Reporting (STAR), California High School Exit Exam (CAHSEE), and California Alternate Performance Assessment (CAPA).

Validation of correct processing of the data is attempted by dual processing of data on the separate systems. The programmer of the first system processes the input data initially then provides an output file to the programmer for the second system who then processes the same input data and compares results between the two systems. Neither system programs produce logs or other evidence of the results of the processing of the records. No formal documented processes exist to evidence that this review is performed.

The requirements to assess LEAs needing improvement are subject to change periodically, requiring changes to be made to reconfigure the system(s) calculations based on the new requirements. Tests are run to confirm the correct configuration, however test results are not retained and the system(s) do not generate logs or other material to confirm either valid or invalid data. No formal change review process exists for this process. Without proper controls in place to assess the accuracy and completeness of the data, Education will not be able to accurately identify LEAs needing improvement.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current system controls to provide for audit trails or other evidence to support that all edit checks are cleared and changes are properly configured to reduce the risk of potential material inaccuracies in the assessment of schools or LEAs needing improvement.

Department's View and Corrective Action Plan:

Education will enhance controls by requiring staff to document output data file edit checks, and sign assurances validating that data has been compared and reconciled between systems.

Reference Number:	2006-14-5
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A050005; 2005
Category of Finding:	Special Tests & Provisions—Subgrant Process
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 20—EDUCATION, CHAPTER 70—STRENGTHENING AND IMPROVEMENT OF ELEMENTARY AND SECONDARY SCHOOLS, SUBCHAPTER I—IMPROVING THE ACADEMIC ACHIEVEMENT OF THE DISADVANTAGED, Part C—Education of Migratory Children, Section 6394. State applications; services, (d) Priority for services:

In providing services with funds received under this part, each recipient of such funds shall give priority to migratory children who are failing, or most at risk of failing, to meet the State's challenging State academic content standards and challenging State student academic achievement standards, and whose education has been interrupted during the regular school year.

Condition:

The subgrant approval process includes a review and approval from an Education department official of the data compiled by a subcontractor that takes into account the numbers, needs, priority-for-services, and availability of funds, but there was no documented evidence of this review and approval of the work performed by the subcontractor. Without evidence of controls and monitoring performed over the subcontractor, Education risks that materially inaccurate data may be compiled and reported without being detected.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current policies and procedures to include that a detailed review be performed and evidenced as part of its subgrant approval process to reduce the risk of material inaccuracies in award calculations.

Department's View and Corrective Action Plan:

Education will strengthen policies and procedures to reduce the risk of material inaccuracies in award calculations by implementing a subgrant approval process and documenting review conclusions. The review and approval process will include: (1) reviewing LEA data and required No Child Left Behind (NCLB) reports to discuss and/or correct problems or inefficiencies; (2) data accuracy comparisons between LEA and vendor reports; and (3) onsite monitoring for validating child eligibility and counts.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Summary of Findings and Questioned Costs
June 30, 2006

Reference Number:	2006-1-1
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	H23/CCH922507-04-1; 2006, 05-0505CA5048; 2005
Category of Finding:	Allowable Costs/Cost Principals
State Administering Department:	Department of Health Services (Health Services)

Criteria:

1. State plan under Title XIX of the Social Security Act State: California Supplement 2 to attachment 4.19-B:

   - The method used to establish maximum drug product payments is that payments for drugs dispensed by pharmacists shall consist of the State's Established Acquisition Cost (EAC) of the drug product dispensed plus a dispensing fee that is added to the drug product payment. The EAC is the lowest of the Average Wholesale Price (AWP) minus 17%; the Maximum Allowable Ingredient Cost (MAIC); the federal upper limit of reimbursement for listed multiple source drugs (called "Federal Upper Limit," or FUL); or the charges to the general public.

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, Part 447—Payments for Services, Subpart B, Payment Methods: General Provisions, Section 447.201 state plan requirements.

- A state plan must provide that the requirements in this subpart are met.

- The plan must describe the policy and the methods to be used in setting payment rates for each type of service included in the State's Medicaid program.

2. OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments,* Attachment A, General Principles for Determining Allowable Costs, Part C. Basic Guidelines

   - Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria: Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

   California Code of Regulations, Title 22, Section 51476:

   - Each provider shall keep, maintain, and have readily retrievable, such records as are necessary to fully disclose the type and extent of services provided to a Medi-Cal beneficiary. Required records shall be made at or near the time at which the service is rendered.

Department of Health Services Provider Manual—Provider Regulations

- Medi-Cal requires providers to: Agree to keep necessary records for a minimum period of three years from the date of service to disclose fully the extent of services furnished to the patient. The provider also must agree to furnish these records and any information regarding payments claimed for providing the services, on request, to the California Department of Health Services.

Condition:

In our sample of fee-for-service claims tested, we noted exceptions in 3 of the 50 claims sampled as follows:

1. One drug sample was found using the outdated average wholesale price (AWP) in the payment calculation, which resulted in a $52.44 underpayment to the provider. Average wholesale prices are obtained from First DataBank. The price effective date is based on the wholesaler's effective dates, which are announced within days of the effective date. Health Services and the State's fiscal intermediary, Electronic Data Systems (EDS), do not timely update the AWP by the effective date. Therefore, the State may process incorrect payments due to timing differences in rate adjustments. Providers may resubmit the claim for adjustment if the incorrect effective rates were used.

2. We could not determine the medical necessity of 2 of the 50 claims tested. The provider was unable to provide supporting documentation, such as medical records, for the claims in question.

Total expenditures for the Medicaid Program amounted to approximately $18 billion* for the fiscal year ended June 30, 2006. Due to the nature of these types of medical claim expenditures no individually material claims were sampled, however, the exceptions found are an indication of potential material noncompliance for claims paid based on the sample selected.

Questioned Costs:

$4,552 of the $256,528 sampled*

* The amounts represent both the state and federal dollars paid to providers. We were unable to determine the federal portion on an individual claim basis. See finding 2006-12-4 for further details.

Recommendations:

We recommend that Health Services implement a process to expedite the input of rate adjustments into the California Medicaid Management Information System (CA-MMIS) to ensure providers are paid using the effective rates as stated in the state plan requirement. The internal control process may include implementing an Erroneous Payment Correction (EPC) query for claims paid using incorrect AWP rates. We also recommend Health Services strengthen its internal control process to detect providers in violation of record retention rules.

Department's View and Corrective Action Plan:

1. Health Services agrees with the audit findings and has already implemented changes to the California Medicaid Management Information System (CA-MMIS) to perform weekly price updates to the formulary file beginning January 1, 2006.

When the formulary file on the CA-MMIS was designed in the early 1980's, the Medi-Cal Program was using local level Medi-Cal codes to pay for drugs. At that time, updates to the formulary file were manual and relied on manufacturers to send Health Services updates on pricing. With the 1988 Medi-Cal Request for Proposal (RFP), the Fiscal Intermediary (FI) Contractor began using a Drug Pricing Clearinghouse, First DataBank (FDB), to update the prices on the file for selected drugs. Although this assisted on some drugs, the process still had many manual interventions. In addition, claims were sent to the Medi-Cal Program on paper or electronic tape media (CMC). In 1994, Health Services instituted the use of the National Drug Code (NDC) for claims payment, doing away with the local level codes. This increased the volume of codes needing updates from ten to twenty thousand to over a hundred thousand codes. In addition, claims payment went from paper and CMC to on-line real time claims processing. In order to keep up with pricing updates, the FI Contractor subcontracted with FDB to do all drug-pricing updates on a monthly basis, which is a requirement of the Medi-Cal RFP. These monthly updates are done at the beginning of a month and contain any updates that occurred during the previous month.

Prices for drugs today are changing daily due to market trends, supply and demand, FDA rulings and numerous other factors. Because providers are purchasing on a daily basis from wholesalers and distributors, the ever changing purchase price impacts their ability to provide services to Medi-Cal beneficiaries when Health Services is unable to reimburse these providers the current market value. In addition, the Medi-Cal Program is unable to recognize savings when the price for drugs goes down at any point during the month. Therefore, in order to ensure access for pharmacy services to Medi-Cal recipients and recognize savings from price decreases, Health Services was mandated under Assembly Bill 131 to update the formulary file prices within seven days of notification that a price change has occurred. Beginning January 1, 2006, this change was implemented into CA-MMIS. In addition, a report was created detailing any price changes that occurred on the weekly price updates. From this report, Health Services then runs ad hoc reports against pharmacy claim records to determine the impact on claims that have been submitted to Health Services. If it is determined that claims were impacted by these price changes, an Erroneous Payment Correction (EPC) request is issued to the FI Contractor.

2. Health Services agrees that such controls are necessary to detect providers in violation of records retention rules and currently Health Services has controls in place to detect providers who do not maintain proper records to support the claims they submit for reimbursement. It is important to recognize that Health Services has a number of processes in place to review and detect this; however, more than 200 million fee-for-service claims are processed and paid annually which prohibits examination of 100% of the claims and supporting documentation. Health Services conducts various pre-payment and post-payment reviews of providers to detect violations of record retention rules.

   Random Claims Review is a pre-payment review of randomly selected claims. Providers are required to submit supporting documentation before payment of the claims is approved. Self-Audits, Field Audit Reviews, and Audit for Recoveries are post-payment reviews. Providers are asked to submit records to support Medi-Cal payments made during prescribed record retention periods as specified in the provider manual. If the provider is unable to supply the supporting documents, recoveries for the unsupported services are made and/or recommendations are made for a more detailed review.

   Of the 50 claims reviewed there were two claims where the provider was unable to provide sufficient supporting documentation. The provider of the first claim did not provide documentation to support the claim for an outpatient hospital visit. A field audit review (FAR) has been requested for this facility. Additional claims will be selected and reviewed for medical

necessity and supporting documentation. The provider of the second claim provided partial documentation to support the medical necessity of a 17 day inpatient hospital stay. A small portion of the ancillary services from the 17 day stay was not documented. Reimbursement of hospital ancillary charges is based on costs to charge ratios. The costs to charge ratios are reviewed for propriety during the hospital's annual cost report audit. Adjustments are made to the cost report for any discrepancies. The annual cost report audit for the hospital is scheduled to be completed and issued by the end of the fiscal year.

Reference Number:	2006-1-2
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0605CA5048; 2006, 05-0505CA5048; 2005
Category of Finding:	Allowable Costs/Cost Principals
State Administering Department:	Department of Health Services (Health Services)

Criteria:

OMB Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments, Attachment A, General Principles for Determining Allowable Costs, Part C. Basic Guidelines

- Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:
  - Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

Condition:

During our procedures performed over the Medi-Cal program, we reviewed all available audit and investigations reports related to the program that were published and released during the fiscal year ended June 30, 2006. The following is a summary of the findings cited in the second annual *Medi-Cal Payment Error Study (MPES)* performed during the fiscal year 2004–2005:

> "The sampling strategy . . . included 1,123 (Fee-For-Service (FFS) and Dental Program) claims, (with. . . a minimum of 50 claims from each stratum to ensure that statistically valid conclusions could be drawn. . . Also added to the review process in the MPES 2005 was reviewing for vulnerabilities in the eligibility process for both FFS and Medi-Cal Managed Care.
>
> (The results of the MPES indicated that) 8.40% of the total dollars paid had some indication that they contained a provider error. Included in the claim errors are those attributable to compliance issues. The dollars associated with such claims are not considered "at risk" of having been paid inappropriately by the Medi-Cal Program.

These compliance errors are a subset of the 8.40%, representing 0.97% of the total dollars paid. The remaining 7.43% represents the percentage of payment errors attributable to Medi-Cal program dollars "at risk" of being paid inappropriately. The 8.40% equates to $1.4 billion of the total $16.8 billion annual payments made for FFS medical and dental services in calendar year 2004. Of the $1.4 billion in annual payments, $1.25 billion are viewed as being "at risk" of being paid inappropriately. The $1.25 billion represents payments for claims with errors, such as a lack of medical necessity, abuse, or fraud. It does not include payments for claims with compliance errors. Of the total payments, 3.23%, or $542 million, were for claims submitted by providers that disclosed characteristics of potential fraud.

(In addition), the MPES 2005 reviewed all 1,123 claims within the sample study design to determine if the FFS beneficiary was eligible for Medi-Cal at the time he/she received services. The review of the claims found that 5.5% of "Medi-Cal only" beneficiaries within the MPES sample were in error due to the beneficiary being ineligible. The sample reviewed was not a random sample of FFS beneficiaries but rather the sample of 1,123 FFS claims reviewed as part of MPES. The eligibility errors are not included in the 8.40 percentage of payment error calculation since the MPES focuses on payment errors due to provider behavior rather than due to errors in the eligibility determination process.

(Lastly), the MPES also included a review of the eligibility of 1,000 managed care beneficiaries and found 56 eligibility errors, or 5.6%."

Based on the error percentages related to Medi-Cal payments and incorrect eligibility determinations, the risk of noncompliance with allowable costs and activities and eligibility is considered material.

Questioned Costs:

Unknown

Recommendations:

We recommend that Health Services strengthen internal control procedures to prevent, deter, and detect potential overpayments to providers and follow existing policies and procedures to ensure payments are made for allowable services and to eligible recipients.

Department's View and Corrective Action Plan:

Health Services concurs with the above recommendation and will continue to implement the corrective action steps outlined in the MPES 2005.

The annual MPES provides opportunities for identifying new patterns of payment errors and areas of potential fraud, waste, and abuse in the Medi-Cal program. The MPES findings reinforce the need to continuously and systematically identify those areas of the program most vulnerable to fraud and abuse and to use these findings to guide Health Services in its allocation of fraud control resources and its development of innovative anti-fraud strategies and fraud prevention tools.

The MPES 2005 did identify newly emerging fraud and abuse patterns. Health Services has initiated corrective actions for all providers identified in the study against which actions are warranted. In addition, Health Services will take additional actions to focus anti-fraud efforts on those areas identified by the study as most vulnerable to fraud and abuse. These additional actions include: on-site reviews of 2,000 pharmacies, expanded use of new technology to better identify potential fraud schemes, reform of the Adult Day Health Care (ADHC) program, an increase of the

number of investigational and routine field compliance audits, and development of a joint action plan with provider regulatory boards and provider associations to address provider claiming errors identified as potential fraud and abuse.

The MPES 2005 can be downloaded at www.dhs.ca.gov/ane.

Reference Number:	2006-1-4
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0605CA5048; 2006, 05-0505CA5058; 2005
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 431—STATE ORGANIZATION AND GENERAL ADMINISTRATION—Subpart A—Single State Agency, Section 431.10 Single State agency.

Authority of the single State agency. In order for an agency to qualify as the Medicaid agency:

- The agency must not delegate, to other than its own officials, authority to:
  - Exercise administrative discretion in the administration or supervision of the plan, or
  - Issue policies, rules, and regulations on program matters.
  - The authority of the agency must not be impaired if any of its rules, regulations, or decisions are subject to review, clearance, or similar action by other offices or agencies of the State.
  - If other State or local agencies or offices perform services for the Medicaid agency, they must not have the authority to change or disapprove any administrative decision of that agency, or otherwise substitute their judgment for that of the Medicaid agency with respect to the application of policies, rules, and regulations issued by the Medicaid agency.

Condition:

Business users (who do not have any system administration responsibilities) have full, unrestricted administrative access to the Centers for Medicare and Medicaid Services 64 (CMS-64) database. Administrative users have the ability to change data and disable any controls on the system, thereby removing traceability of the actions of the user.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Health Services implement system access and segregation of duties controls. Only personnel with system administrative duties and no program responsibilities should be given administrative access to the system. Further, adequate system-based capability should be developed to provide the required data-correction capability with adequate controls and safeguards.

Department's View and Corrective Action Plan:

Health Services agrees with reservations.

Some important elements of the current CMS-64 Accounting System updates are traceable to transaction authors which are recorded in separate tables. For users of the CMS-64 Accounting system, there is no distinction between business users and administrative users.

The Department is in the process of removing access to the CMS-64 Database for all Business and Administrative users. New Update screens are being developed for Accounting staff to allow users to update certain elements of the tables due to either user error or policy decision. The new data corrections screen will protect the system with adequate controls, safeguard the data, and eliminate user errors.

Reference Number:	2006-2-1
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention–Investigations and Technical Assistance
Federal Award Numbers and Calendar Years Awarded:	U55/CCU921920; 2006, U55/CCU921920; 2005 U90/CCU917016; 2006, U90/CCU917016; 2005
Category of Finding:	Allowable Costs/Cost Principles
State Administering Department:	Department of Health Services (Health Services)

Criteria:

OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments*, Attachment B, Selected Items of Cost, Part 8 Compensation for Personnel Services, Section H Support of salaries and wages:

- Where 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 the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi-annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

Condition:

Health Services did not ensure that employees who worked full-time on the Breast and Cervical Cancer Control Program consistently completed the required payroll certifications. In our sample of employees that worked full-time on the program, Health Services was unable to locate the required certifications for the two employees sampled for testing.

Health Services also did not ensure that employees who worked full-time on the Public Health Preparedness and Response for Bioterrorism Program consistently completed the required payroll certifications. In our sample of employees that worked full-time on the program, Health Services was unable to locate the required certifications for five of the twenty-five employees sampled for testing.

By not maintaining required personnel services documentation in accordance with OMB Circular A-87, Health Services did not comply with Federal principles for allowable costs.

Questioned Costs:

$10,092 of the $10,092 sampled for the Breast and Cervical Cancer Control Program

$24,530 of the $122,649 sampled for the Public Health Preparedness and Response for Bioterrorism Program

Recommendations:

We recommend Health Services enhance current policies and procedures to ensure employees complete required payroll certifications and that those certifications be retained in accordance with Federal and State record retention requirements.

Department's View and Corrective Action Plan:

In response to past audit reports, Health Services' Public Health Preparedness and Response for Bioterrorism Program established a process for supervisors to collect the certification forms. However, when Health Services went to supervisors to collect the forms in response to requests from the auditors, certifications for employees who had left the office could not be located. Therefore, Health Services has changed its procedures for collecting the required certifications to make it the responsibility of the personnel analyst who will maintain the certifications in a central location.

Health Services' Breast and Cervical Cancer Control Program agrees with the recommendation. This was the first year that these certification documents were not up to date. Health Services will bring all necessary documents up to date by the end of February 2007.

Reference Number:	2006-3-2
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention–Investigations and Technical Assistance
Federal Award Number and Calendar Year Awarded:	U90/CCU917016; 2005, U90/CCU917016; 2006

Category of Finding: Cash Management

State Administering Department: Department of Health Services (Health Services)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.21 Payment.

- Interest earned on advances. Except for interest earned on advances of funds exempt under the Intergovernmental Cooperation Act (31 U.S.C. 6501 et seq.) and the Indian Self-Determination Act (23 U.S.C. 450), grantees and subgrantees shall promptly, but at least quarterly, remit interest earned on advances to the Federal agency. The grantee or subgrantee may keep interest amounts up to $100 per year for administrative expenses.

TITLE 45—HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.25 Program income:

- Grantees are encouraged to earn income to defray program costs. Program income includes income from fees for services performed, from the use or rental of real or personal property acquired with grant funds, from the sale of commodities or items fabricated under a grant agreement, and from payments of principal and interest on loans made with grant funds. Except as otherwise provided in regulations of the Federal agency, program income does not include interest on grant funds, rebates, credits, discounts, refunds, etc. and interest earned on any of them.

Condition:

During our procedures performed over cash management of the subrecipients, we noted Health Services did not require subrecipients to return interest earned on advances from the Federally funded program. Subrecipients are notified that any interest earned on cash advances is to be used for purposes of the program only. Interest earned on program advances does not fall under the program income regulations unless specifically provided in the Federal awarding agency regulations or terms and conditions of the award. We were unable to locate this authorization in the grant award document, agency regulations, or obtain a copy of any specific authorization from the Federal Department Health and Human Services that granted Health Services the authority to regrant the interest earned. The amounts of interest earned and expended are reported annually to Health Services, however it was unable to provide an estimate of the totals of interest earned and expended for the fiscal year.

Questioned Costs:

Not determined

Recommendations:

We recommend that Health Services establish processes and controls to communicate and obtain this information from the subrecipients as well as to collect and return the funds back to the federal government, as applicable.

Department's View and Corrective Action Plan:

Health Services is following State statute regarding local use of interest earned on these federal funds. Health and Safety Code Section 101317(f) requires any local health jurisdiction that receives these funds to deposit them in a special local public health preparedness trust fund established solely for local preparedness purposes before transferring or expending the funds for any of the allowed uses and further states that interest accrued to the benefit of the fund shall be expended for the same purposes as other moneys in the fund.

Auditor's Comment on Department's View:

Health Services statement that the enacted State statue regarding local use of interest earned on Federal funds exempts them from having to comply with Federal requirements is not accurate. State statues do not supersede Federal laws in regard to Federally funded program requirements. We recommend the State seek guidance and approval from the U.S. Department of Health and Human Services.

Reference Number:	2006-3-11
Federal Catalog Number:	93.283
Federal Program Title:	Centers for Disease Control and Prevention–Investigations and Technical Assistance
Federal Award Number and Calendar Year Awarded:	U90/CCU917016; 2006, U90/CCU917016; 2005
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.21 Payment.

- Advances. 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.

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.20 Standards for financial management systems:

- Cash Management. Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and

cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

Health Services does not have procedures in place to ensure that the Public Health Preparedness and Response to Bioterrorism program's subrecipients can 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. Specifically, the California Health and Safety Code, sections 101317(d)(1) and (2), require 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. Subsequent payments are made 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, we noted that Health Services does not have a process in place for assessing the cash needs of its subrecipients and does not require any periodic expenditure reporting or input by the subrecipients during the award period.

As a result of these weaknesses, Health Services disbursed approximately $52.7 million during fiscal year 2005–2006 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 2005–2006 totaling more than $6 million.

Questioned Costs:

Not determined

Recommendations:

We recommend that Health Services review its current policies and procedures over cash advances to subrecipients to monitor and match the cash needs of the subrecipients with the timing of the payments to minimize the time elapsing between the advance of federal funds and expenditure by the subrecipient.

Department's View and Corrective Action Plan:

Health Services disagrees with the following statement from the condition above—"does not require any periodic expenditure reporting or input by the subrecipients during the award period." CDHS requires local health departments to submit semi-annual expenditure reports which are reviewed by staff to ensure the expenditures are in accordance with the approved budget.

Health Services disagrees with the finding because: (1) Health Services is required by federal law to comply with state law, which expressly requires quarterly payments; (2) there is no guidance nor criteria upon which to base a finding that a quarterly payment is inconsistent with the federal timely disbursement requirement; and (3) the federal regulations provide for, contemplate, and acknowledge alternative methods of disbursing grant funds and circumstances under which a grantee would not be able to meet the requirement to minimize the time between receipt and disbursement of funds.

First, the auditor refers to federal regulations applicable to these grants, but ignores a threshold criteria applicable to financial administration of the grant. Specifically, federal regulations on financial administration of the grant first require that states “must expend [sic] and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. (42 CFR 92.20(a), emphasis provided). Therefore, by federal rule, California is required to comply with its own laws applicable to this grant. That directly brings into play the State statutory requirements of Health & Safety Code Section 101317(d), and others that apply generally to financial administration of grant funds. Health & Safety Code Section 101317(d) mandates that funds “shall be disbursed quarterly to local health jurisdictions. Accordingly, the State is required by federal rule to disburse funds quarterly.

Second, the audit bases its findings in large part on the timely disbursement criteria without any statutory or legal standard upon which timeliness is measured, or to conclude that quarterly payments are inconsistent with the federal requirement to minimize the lapse in time. Health Services was unable to find a regulation that addresses or provides a measurement for what constitutes an appropriate timeframe. There is also nothing upon which to base a conclusion that a quarterly disbursement schedule is inconsistent with the federal requirement of minimizing the time lapse between receipt of funds and disbursements. As an aside, an argument can be made that the requirement to minimize the time lapse between the receipt and disbursement of funds applies whenever advance payment procedures are used. (42 CFR 92.20(b)(7).

The third area under which this audit finding is vulnerable is that the federal regulations on post-grant award requirements provide for several alternative methods of payment and acknowledge there will be circumstances under which a state cannot meet the time lapse requirement. The methods of payment include advance payments, reimbursement, and cash or a working capital advance basis (42 CFR 92.21). The “Basic Standard” for payment requires methods and procedures in place to “minimize the time elapsing between the transfer of funds and disbursement by the grantee or subgrantee, in accordance with Treasury regulations at 31 CFR Part 205.” (Again, the Treasury regulations contain provisions for funding and discretion to add other requirements in the event the federal or state government agencies do not comply with the requirements, including timely disbursement.) The regulation provides for alternative methods or standards for payment including but not limited to the “Basic Standard” with the timely disbursement requirement. In addition to providing alternative methods, the regulations also contemplate situations when states or subgrantees cannot meet the timely disbursement requirements. Specifically, the reimbursement method of payment is to be used when the “requirements of paragraph (c) of this section [procedure for timely disbursement] are not met.” This language expressly acknowledges and authorizes alternative methods of disbursing grant funds outside the timely disbursement criteria.

Health Services concludes that both the State and federal requirements for grant financial funding apply. Both contain timely administration of payment criteria which are not inconsistent. State disbursement requirements are quarterly. Federal requirements must ensure a procedure to limit any time lags between receipt and disbursement of funds. It is unclear how a quarterly disbursement is inconsistent or noncompliant with a procedure that minimizes the time between receipt of grant funds and disbursements. Without specific criteria, there is nothing upon which to base a finding that these timeframes are inconsistent. Moreover, with the federal regulation requiring states to administer grant funds in accordance with state requirements, doing anything other than quarterly disbursements (or whatever methodology required by state law) would violate this federal requirement. Assuming the State is disbursing funds in accordance with state law (including but not limited to H&S 101317), and has a procedure in place that minimizes the lapse in time between receipt and disbursement of grant funds, it is reasonable to conclude that the grant funds are being administered in accordance with federal requirements.

Bureau of State Audits' 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:	2006-3-12
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster—Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Number and Calendar Year Awarded:	G-0601CACCDF; 2006
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 34—HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.20 Standards for financial management systems:

- Cash Management—Procedures for minimizing the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by grantees and subgrantees must be followed whenever advance payment procedures are used. Grantees must establish reasonable procedures to ensure the receipt of reports on subgrantees' cash balances and cash disbursements in sufficient time to enable them to prepare complete and accurate cash transactions reports to the awarding agency. When advances are made by letter-of-credit or electronic transfer of funds methods, the grantee must make drawdowns as close as possible to the time of making disbursements. Grantees must monitor cash drawdowns by their subgrantees to ensure that they conform substantially to the same standards of timing and amount as apply to advances to the grantees.

Condition:

During our procedures performed over claim payments made to Local Educational Agencies (LEAs) and subrecipient contractors, we noted Education requests cash advances from the federal government and then requests payments to be made to the LEAs and contractors by the State Controller's Office (SCO).

For these programs that are included in the Cash Management Improvement Act (CMIA) agreement between the U.S. Department of the Treasury and the State, we noted required funding techniques of pre-issuance for its payments to LEAs and monthly estimate/monthly draw for subrecipient contractors. The pre-issuance technique requires the State to disburse cash advances to LEAs not more than three days after the advance is deposited in the State account. For the non-preissuance payments, Education has adopted an internal policy of 14 days as a reasonable amount of time between the advance of federal funds and the disbursement made to the contractor.

Education has a control process in place to reconcile and follow up on a monthly basis any outstanding LEA payment requests submitted to the SCO from advanced federal funds that remain unpaid after 60 days. The practice of only following up on items 60 days past due would not enable Education to determine whether or not it is in compliance with Federal requirements for minimizing the time elapsing between the request for advance from the Federal government and the payment being made to the subrecipient.

Without appropriately designed controls in place, Education risks payments not being made in accordance with Federal guidelines which could cause Education to be required to switch from the advance basis to a reimbursement basis from the awarding agency. We understand that Education is in the process of strengthening controls to ensure that reconciliations of any unpaid LEA payment requests are performed more timely.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen processes, controls, and communication with the SCO to reduce the amount of time before follow up is made on outstanding payments not yet been made by the SCO to reduce the risk of potential material noncompliance.

Department's View and Corrective Action Plan:

For payment of claims, the procedures followed by Education fall either under those established by the Department of Finance (DOF) with agreement by the SCO for CMIA or those that follow the process governed by the California Prompt Payment Act. CMIA claims are paid within three days and for all others the SCO has 15 days in which to issue payment. In an effort to further strengthen existing controls, Education has changed the timeframe it waits to follow up on any outstanding claims to 30 days.

Reference Number:	2006-3-13
Federal Catalog Number:	93.994
Federal Program Title:	Maternal and Child Health Services Block Grant to the States
Federal Award Number and Calendar Year Awarded:	B04MC04274-01-03; 2004, B04MC06558-01-03; 2004

Category of Finding: Cash Management

State Administering Department: Department of Health Services (Health Services)

Criteria:

TITLE 42—THE PUBLIC HEALTH AND WELFARE, CHAPTER 7—SOCIAL SECURITY, SUBCHAPTER V—MATERNAL AND CHILD HEALTH SERVICES BLOCK GRANT, Section 701. Authorization of appropriations; purposes; definitions:

- To improve the health of all mothers and children consistent with the applicable health status goals and national health objectives established by the Secretary under the Public Health Service Act (42 U.S.C. 201 et seq.) for the year 2000, there are authorized to be appropriated $850,000,000 for fiscal year 2001 and each fiscal year thereafter for the purpose of enabling each State:

  – to provide rehabilitation services for blind and disabled individuals under the age of 16 receiving benefits under subchapter XVI of this chapter, to the extent medical assistance for such services is not provided under subchapter XIX of this chapter; and

TITLE 31—MONEY AND FINANCE: TREASURY, CHAPTER II—FISCAL SERVICE, DEPARTMENT OF THE TREASURY PART 205—RULES AND PROCEDURES FOR EFFICIENT FEDERAL—STATE FUNDS TRANSFERS—Subpart B—Rules Applicable to Federal Assistance Programs not Included in a Treasury-State Agreement, Section 205.33 How are funds transfers processed?

- A State must minimize the time between the drawdown of Federal funds from the Federal government and their disbursement for Federal program purposes. A Federal Program Agency must limit a funds transfer to a State to the minimum amounts needed by the State and must time the disbursement to be in accord with the actual, immediate cash requirements of the State in carrying out a Federal assistance program or project. The timing and amount of funds transfers must be as close as is administratively feasible to a State's actual cash outlay for direct program costs and the proportionate share of any allowable indirect costs. States should exercise sound cash management in funds transfers to subgrantees in accordance with OMB Circular A-102 (For availability, see 5 CFR 1310.3.).

- Neither a State nor the Federal government will incur an interest liability under this part on the transfer of funds for a Federal assistance program subject to this subpart B.

Condition:

During the fiscal year ending June 30, 2006, Health Services used $6 million in Maternal, Child, and Adolescent Health (MCAH) cash advances to operate the California Child Services (CCS) Medical Therapy Program. The CCS Medical Therapy Program is administered by California school districts and provides physical therapy for all eligible school children in the state of California. The MCAH regulations prohibit the use of the grant funds to pay for rehabilitation services to individuals under 16 years of age, if these services are available through the Medicaid Program. Health Services advanced funds on July 29, 2005 from the MCAH program to pay for services provided under the CCS Medical Therapy Program, which are not allowable under MCAH regulations. These cash advances were not repaid to the MCAH program by the Medicaid Program until May 3, 2006. The approximate 9 months from when these cash advances were drawn down from the MCAH letter of credit in July 2005 until they were reimbursed by the Medicaid Program in May 2006 were not for the immediate cash needs of the MCAH program in accordance with cash management requirements.

Questioned Costs:

Not determined

Recommendations:

We recommend that management limit fund draw downs to the minimum amounts needed by the program and for immediate cash requirements as required by the grant's funding technique.

Department's View and Corrective Action Plan:

We do not agree with the statement made in the condition portion of the audit finding and do not believe there is a valid finding. It is stated that the expenditures in question are cash advances of federal funds. The funds were drawn down from the Federal Government to cover expenditures that CDHS considered to be appropriate federal activities. As soon as it was discovered that these expenditures should not have been charged to the Federal Funds, an adjustment was made to our Accounting System to correct the appropriate funding and the money was returned to the Federal Agency. This does not constitute an advance.

In addition, we do not concur that for the time period that federal monies were used for the CCS rehabilitation program require any penalty consideration in this context, US Treasury Rule and Regulations 31 CFR Part 20 33(b) states that "neither a State nor the Federal government will incur an interest liability under this part of the transfer of funds for a Federal assistance program subject to this subpart B."

In regard to the recommendation regarding limiting fund draws to the minimum required, the CDHS concurs with this statement. This is our business practice and we will continue to strive to limit fund draw downs to the minimum amounts required.

Auditors Response to Department's View

The timeframe cited in the finding refers to the date the funds were drawn down from the Federal letter of credit until they were transferred to the Medicaid Program and disbursed to pay for program expenditures. This program does not meet the threshold to be included under the Treasury State Agreement for specified funding technique; therefore, the criteria would be for the State to minimize the time between the drawdown of the funds and the payment to the vendors for program services.

Health Services had stated that the issue was caught and corrected before the end of the award year and the time the final report was issued. This finding only cites the timing of the MCAH advance drawn down and when it was reimbursed by Medicaid to pay for MCAH program expenditures.

Reference Number:	2006-3-14
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster—Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund

Federal Award Number and Calendar Year Awarded:	G-0601CACCDF; 2006
Category of Finding:	Cash Management
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.20 Standards for financial management systems.

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and
- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

Condition:

During our procedures performed over sub grant claim payments made to subrecipients, we tested Education's control processes over those payments, which include a signed approval that is documented on a *Request for Payment of a Non-Formula Grant* (Form AO-401 rev. 01/02). The *Request for Payment of a Non-Formula Grant* forms are required to be signed by the Division Director in accordance with the Delegation of Authority Policy (Section 2050 of the Department of Education Administrative Manual, effective August 2, 1999). In our sample of 50 *Request for Payment of a Non-Formula Grant* forms, we noted an approved authorized agent did not sign 11 of the 50 samples on 11 different dates throughout the fiscal year. Upon further inquiry, we noted Education had adopted an informal process where an Administrator I would sign their own name and add "for the director," however this practice is not authorized in the Education Administrative Manual.

After the sub grant payments are approved on the Request for Payment of a *Non-Formula Grant*, the payment requests are forwarded to the Fiscal Service Division to be processed. A Claims Schedule is then prepared by the Fiscal Services Division Accounting Office (Accounting Office) for the amounts approved to be paid and the payment information is input into the California State Accounting and Reporting System (CALSTARS) General Ledger. A supervisor then reviews and approves the work performed by the staff by initialing the *Claims Schedule*. The original copy of the approved *Claims Schedule* is sent to the State Controller's Office (SCO) to be paid, however a copy is not retained as evidence of the review and approval process for the claim. An unsigned copy of the *Claims Schedule* is retained along with the other documentation as support for the payment. In our sample of payments made to Local Educational Agencies (LEAs) and subrecipient contractors, we noted 47 of the 50 *Claims Schedules* sampled did not contain evidence of the review and approval process performed by the Accounting Office. By not retaining the signed copy as evidence of review and approval to ensure accuracy of the payment request data entry into CALSTARS, Education cannot demonstrate support for approvals for payments made to LEAs and subrecipient contractors.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education retain copies of the approved instead of the unapproved *Claims Schedule* as part of the supporting documentation package retained as evidence of controls over the payment approval process. We also recommend that Education strengthen processes to ensure that only authorized personnel approve payments in accordance with the Education Administrative Manual.

Department's View and Corrective Action Plan:

Education has strengthened processes to ensure that only authorized personnel approve payments in accordance with the Department of Education Administrative Manual. Specifically, the Accounting Office will review all invoices and payment requests to ensure that all authorized signatures are obtained before processing payment. Although the State Controller's Office has signature cards on file and will not process a claim for payment unless the original claim is reviewed and signed by authorized personnel, Education will retain copies of claim schedule face sheets that the accounting staff have initialed to indicate approval.

Reference Number:	2006-5-1
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0505CA5048; 2005, 05-0605CA5048; 2006
Category of Finding:	Eligibility
State Administering Department:	Department of Health Services (Health Services)

Criteria:

Social Security Act, Title XIX—Grants to State for Medical Assistance Programs, Section 1920.

(a) A state plan approved under Section 1902 may provide for making ambulatory prenatal care available to a pregnant woman during a presumptive eligibility period.

(c)(1) The State agency shall provide qualified providers with:

(A) such forms as are necessary for a pregnant woman to make application for medical assistance under the state plan, and

(B) information on how to assist such women in completing and filing such forms.

(2) A qualified provider that determines under subsection (b)(1)(A) that a pregnant woman is presumptively eligible for medical assistance under a state plan shall:

(A) notify the State agency of the determination within five working days after the date on which determination is made, and

(B) inform the woman at the time the determination is made that she is required to make application for medical assistance under the state plan by not later than the last day of the month following the month during which the determination is made.

Condition:

The presumptive eligibility component of this program grants immediate and temporary Medi-Cal coverage for California residents who are pregnant but do not have health insurance or Medi-Cal coverage for prenatal care. Health Services grants the right to enroll recipients under this program to qualified providers. Because the program provides immediate and temporary care prior to the approval of Medi-Cal eligibility, recipients enrolled in presumptive eligibility are not considered Medi-Cal eligible, and therefore, are not entered into Health Services' eligibility systems. Recipients presumed to be eligible are assigned a pre numbered ID card (obtained from Health Services by the provider) that begins with a county ID # and presumptive eligibility aid code. The paper documentation, including the application and the Medi-Cal presumptive eligibility identification card, are retained by the provider. The provider is required by the state plan to submit to Health Services a weekly enrollment summary of all presumptive eligibility IDs issued to Health Services for filing. Health Services is to keep the documents for a period of 3 years. Since the supporting documentation for presumptive eligibility is retained by Health Services, the State's fiscal intermediary, Electronic Data Systems (EDS), does not perform procedures over recipients presumed to be eligible. The EDS mainframe processing is set to bypass the eligibility check if it recognizes the special sequencing of the presumptive eligibility ID number.

Of our sample of fee-for-service payments, Health Services' eligibility branch was unable to provide summary enrollment forms to verify the presumptive eligibility status for 2 of the 50 payments sampled.

Questioned Costs:

$376 of the $256,528 sampled*

* The amounts represent both the State and Federal dollars paid to providers. We were unable to determine the federal portion on an individual claim basis. See finding 2006-12-4 for further details.

Recommendations:

We recommend that Health Services strengthen their internal control process to track and obtain the enrollment of presumptive eligibility ID numbers issued to prevent unauthorized use of ID numbers. Further, we recommend that Health Services perform procedures to authenticate the existence of the recipient, prevent duplicate issuances, and reconcile the presumptive eligibility number against the recipient enrollment listing filed at Health Services during the claims adjudication process.

Department's View and Corrective Action Plan:

Health Services partially agrees.

Health Services is unable to reconcile the presumptive eligibility number against the enrollment listing filed with Health Services at this time because of staffing limitations. However, Health Services is pursuing an automated process to post the presumptive eligibility ID to the Medi-Cal eligibility system so that the records for these recipients can be accessed to authenticate, reconcile, and prevent duplicate issuances of the presumptive eligibility number during the claims adjudication process. Health Services is in the process of finding a consultant to begin the process of conducting an independent feasibility study and then will pursue funding to accomplish this automation, as required by Senate Bill 24, Chapter 895, Statutes of 2003.

Reference Number:	2006-5-2
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0505CA5048; 2005, 05-0605CA5048; 2006
Category of Finding:	Eligibility
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 431—STATE ORGANIZATION AND GENERAL ADMINISTRATION—Subpart A—Single State Agency, Section 431.10 Single State agency.(c) Determination of eligibility.

(1) The plan must specify whether the agency that determines eligibility for families and for individuals under 21 is:

- The Medicaid agency; or
- The single State agency for the financial assistance program under Title IV-A (in the 50 States or the District of Columbia), or under Title I or XVI (AABD), in Guam, Puerto Rico, or the Virgin Islands.

(2) The plan must specify whether the agency that determines eligibility for the aged, blind, or disabled is:

- The Medicaid agency;
- The single State agency for the financial assistance program under title IV-A (in the 50 States or the District of Columbia) or under Title I or XVI (AABD), in Guam, Puerto Rico, or the Virgin Islands; or
- The Federal agency administering the supplemental security income program under Title XVI (SSI). In this case, the plan must also specify whether the Medicaid agency or the Title IV-A agency determines eligibility for any groups whose eligibility is not determined by the Federal agency.

TITLE 42—PUBLIC HEALTH, CHAPTER IV--CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 435—ELIGIBILITY IN THE STATES, DISTRICT OF COLUMBIA, THE NORTHERN, Subpart J—Eligibility in the States and District of Columbia, Section 435.916 Periodic redeterminations of Medicaid eligibility.

- The agency must redetermine the eligibility of Medicaid recipients, with respect to circumstances that may change, at least every 12 months.

Condition:

States are required to operate a Medicaid Eligibility Quality Control (MEQC) system in accordance with requirements established by CMS. The MEQC system redetermines eligibility for individual sampled cases of beneficiary eligibility made by State Medicaid agencies, or their designees. The State of California (the State) had been granted a waiver from the traditional MEQC program described in regulation. This waiver differs from the traditional MEQC program by performing special studies, targeted reviews, or other activities that are designed to ensure program integrity or improve program administration. The Health Services MEQC process reviewed 2,734 cases during April 2005 through March 2006. Of the 2,734 cases sampled, Health Services determined that 244 cases were ineligible for Medicaid resulting in a 9 percent error rate.

We evaluated the accuracy of the MEQC system by obtaining a listing of all eligibility case reviews performed by the State during the fiscal year and chose a sample of 120 cases to reperform the State's MEQC review at 10 different counties. Our sample of 120 Medicaid recipients included 103 that were deemed eligible and 17 that were deemed ineligible by the MEQC review process.

1. Our reexamination indicated 1 of the 103 Medicaid recipients deemed eligible by the MEQC process was actually ineligible for Medicaid benefits. We noted a deceased beneficiary had remained Medi-Cal eligible for almost two years post mortem. The beneficiary was a Supplemental Social Security 2.3% cut beneficiary who had been discontinued from Supplemental Social Security (SSI) in 1994, but was still eligible for Medi-Cal benefits as his/her income level was below Supplemental Social Security payment levels. This sample was examined by MEQC reviewers who performed limited scope reviews (by examining the information noted in the Medi-Cal Eligibility Determination System) and was not cited as a finding.

   The results of the MEQC review were incorrect as the individual was deceased in the month of review and was erroneously classified as eligible for Medi-Cal benefits. There is a risk that claims can be submitted on behalf of this individual (or using the individual's Medi-Cal ID) post mortem.

2. Further, of the 120 MEQC sampled cases re-examined, the State did not take appropriate corrective action to follow up for two cases and the MEQC eligibility determination was incorrect for one case. The results of these two MEQC errors are as follows:

   - One recipient had not undergone the required eligibility redetermination and was ineligible for Medi-Cal benefits in the month of review (September 2005). Although the error was noted by the MEQC reviewers, no corrective action was taken. Per examination of the case file in September 2006, the individual had not performed an annual redetermination of eligibility since 2004, but was still active as a Medi-Cal beneficiary. There is the risk that the individual/family will continue to receive medical benefits and be able to submit claims for medical services provided for which the individual is no longer eligible.

   - Another recipient had not undergone the required eligibility redetermination and was ineligible for Medi-Cal benefits in the month of review (January 2006). This case was examined by the MEQC review in April 2006. The individual had re-applied for benefits in

March 2006, and therefore, at the time of the MEQC review in April 2006, there was no corrective action necessary as eligibility was re-established. However, it was discovered that the beneficiary had an increase in income that had not been updated in the State eligibility system in March 2006, which potentially could cause the beneficiary to no longer be eligible for Medi-Cal benefits, as the income increase appeared to exceed the income limitations for the 1931(b) sub program of Medi-Cal under which the individual was receiving aid.

Recommendations:

We recommend that Health Services strengthen internal controls over the MEQC process. We also recommend procedures be implemented to ensure cases with errors are addressed and resolved within a timely manner.

Questioned Costs:

Unknown

Department's View and Corrective Action Plan:

1. Health Services agrees with the condition #2 noted above. Counties are aware of the expectation of Health Services that all errors identified through the MEQC review process are to be corrected in a timely manner. Health Services has a Corrective Action Review (CAR) process for MEQC that requires that Program Review Section (PRS) complete follow up reviews on eligibility and procedural errors semi-annually with all counties.

   The county that was cited for these exceptions was advised of the need for corrective action at the time the error citation was issued and again through the CAR process when the corrective action did not occur. Historically, counties have consistently corrected 97% of all errors. The referenced error was one of the few that counties did not correct. PRS staff followed up with the affected county and reiterated our expectations.

2. Health Services generally agrees with condition #1 noted above. The Medi-Cal beneficiary was a SSI-SSP 2.3% cut beneficiary. Please note the following from All County Welfare Directors' Letter 94-81, "2.3% beneficiaries who lost their SSI-SSP due to this cut will receive zero SOC-Medi-Cal until their incomes, aside from any Cost Of Living Adjustments (COLA), exceed the SSI-SSP benefit levels had the September 1, 1994 benefit reduction not occurred or their living arrangements, resources, and/or residency change in a way that would make them ineligible. Even though 2.3% beneficiaries are not required, at this time, to go to the county welfare departments (CWDs), CWDs may sometimes be informed of a 2.3% beneficiary's change in financial situation (such as becoming resource ineligible or entering a long-term care facility), death, or change of address."

   Thus, the county did not have a case record on file for the beneficiary. As the county was never informed of the death of the beneficiary, no action was taken to discontinue Medi-Cal.

   Health Services will evaluate the feasibility of adding a death match alert notification as part of the Eligibility Worker alert process that is part of the Medi-Cal Eligibility Data Systems (MEDS). Although MEDS currently has a data field that displays this information, an automated update cannot be completed when a death match or automated death data is received. The State must confirm that the beneficiary is deceased before benefits can be terminated. This process would provide an additional control so that counties may be apprised of the death of a beneficiary in the event that the responsible relatives do not report this information directly.

Because the responsibility for this group of Medi-Cal beneficiaries is the responsibility of the State and not the counties, procedures for controlling these cases will be reviewed with the appropriate State policy staff.

Reference Number:	2006-5-4
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	5-0505CA5048; 2005, 5-0605CA5048; 2006
Category of Finding:	Eligibility
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 431—STATE ORGANIZATION AND GENERAL ADMINISTRATION, Subpart P Quality Control, Section 431.806 state plan requirements.

- MEQC program—A state plan must provide for operating a Medicaid eligibility quality control (MEQC) program that meets the requirements of Section 431.810 through Section 431.822 of this subpart.

Condition:

Health Services performs limited follow up on errors noted through their focused reviews. While all errors are communicated to the counties once they have been encountered, Health Services only performs corrective action reviews on the focused reviews with less than 90% accuracy within 12 months of the initial review. Therefore, there is the risk that errors, although reported, may continue to remain uncorrected. In the counties in which follow up reviews are performed, there is the risk of the error continuing to exist for up to a full year without appropriate corrective action being taken.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Health Services strengthen their systems of internal controls to ensure errors noted on the Focused Reviews are being corrected. We also recommend that Health Services receive verification of the corrective action performed over all errors encountered during focused reviews performed. This would mitigate the risk of errors continuing to be uncorrected.

Department's View and Corrective Action Plan:

Health Services generally agrees.

The purpose of Focused Reviews (FR) is to evaluate a county's performance on a specific area of Medi-Cal eligibility. Unlike the Med-Cal Eligibility Quality Control (MEQC) review process, a full eligibility evaluation is not always conducted during FRs.

For FRs, when a county performs below expected performance standards, state and county staff discuss and reach agreement on review issues and required remedial actions, commit to a follow up review after a reasonable time interval to implement remedial actions, and review specific requirements and expectations. As of January 1, 2007, all future FR findings letters will include the following statement in terms of correction of all negative review findings:

> "We have confirmed with NAME that NAME County staff will take corrective action on all cases identified with eligibility errors, procedural errors or pertinent information issues."

In addition, state staff will selectively monitor county efforts to address and correct FR case issues, based on experience, magnitude and significance of error findings, circumstances, and loss potential.

Reference Number:	2006-7-8
Federal Catalog Number:	93.994
Federal Program Title:	Maternal and Child Health Services Block Grant to the States
Federal Award Number and Calendar Year Awarded:	B04MC04274-01-03; 2004, B04MC06558-01-03; 2004
Category of Finding:	Earmarking
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—THE PUBLIC HEALTH AND WELFARE, CHAPTER 7—SOCIAL SECURITY, SUBCHAPTER V—MATERNAL AND CHILD HEALTH SERVICES BLOCK GRANT, Section 705. Application for block grant funds

- The State will use:

  a. at least 30% of such payment amounts for preventive and primary care services for children, and

  b. at least 30% of such payment amounts for services for children with special health care needs (as specified in Section 701(a)(1)(D) of this title);

Condition:

During procedures performed over program earmarking requirements, we noted the Maternal and Child Health Program (MCH) did not track the 30% spending requirement for (a) preventive and primary care for children, or (b) children with special health care needs during the fiscal year ended June 30, 2006. The amounts actually spent for these activities cannot be determined due to inadequate support for earmarking requirements, therefore, we are unable to assess the State's compliance with Federal earmarking requirements.

Questioned Costs:

Unknown

Recommendations:

We recommend that management develop an accounting information system that will properly track and provide timely reporting of grant fund expenditures for the categories—(a) preventive and primary care for children, and (b) children with special health care needs—prescribed by the MCH's earmarking requirements.

Department's View and Corrective Action Plan:

We concur that sufficient documentation was not available to support final expenditures for the 30% spending requirement for Component (a) preventive and primary care for children, and Component (b) children with special health care needs. In establishing sub-recipient budgets, MCH estimates the funding percentages that will be expended for Components a and b. MCH will ensure documentation is complete showing how budgeted funds were ultimately expended for Components a and b.

Reference Number:	2006-8-2
Federal Catalog Number:	93.268
Federal Program Title:	Immunization Grants
Federal Award Numbers and Calendar Years Awarded:	H23/CCH922507-03-5; 2005, H23/CCH922507-04-1; 2006
Category of Finding:	Period of Availability
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.23 Period of availability of funds.

- General. Where a funding period is specified, a grantee may charge to the award only costs resulting from obligations of the funding period unless carryover of unobligated balances is permitted, in which case the carryover balances may be charged for costs resulting from obligations of the subsequent funding period.

- Liquidation of obligations. 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 (SF-269). The Federal agency may extend this deadline at the request of the grantee.

Condition:

We noted that Health Services did not have the appropriate controls in place to ensure that it charged the Immunization Grants program only for those costs resulting from obligations incurred during the funding period. Although we did not note any instances of noncompliance, without the appropriate controls in place, Health Services risks funds not being obligated within the funding period of the grant and having to return the funds to the federal awarding agency. We understand that Health Services is in the process of implementing controls to ensure that funds are obligated within the funding period.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Health Services ensure that it obligates funds within the appropriate funding period of each grant award.

Department's View and Corrective Action Plan:

Health Services concurs with the finding and subsequent recommendation. To correct this condition Health Services has put check points in place to ensure that contracts are executed during the period of availability. In addition, Health Services has communicated with all contractors to explain the consequential denial of funding if contracts are not signed and submitted to Health Services by the stated deadline.

Reference Number:	2006-8-3
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund (CCDF) Cluster: Child Care and Development Block Grant & Child Care
Mandatory and Matching Funds	of the Child Care and Development Fund
Federal Award Number and Calendar Year Awarded:	G-0301CACCDF; 2003, G-0501CACCDF; 2005
Category of Finding:	Period of Availability
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 98—CHILD CARE AND DEVELOPMENT FUND—Subpart G—Financial Management, Section 98.60 Availability of funds.

The following obligation and liquidation provisions apply to States and Territories:

- Discretionary Fund allotments shall be obligated in the fiscal year in which funds are awarded or in the succeeding fiscal year. Unliquidated obligations as of the end of the succeeding fiscal year shall be liquidated within one year.

- Mandatory Funds for States requesting Matching Funds per Section 98.53 shall be obligated in the fiscal year in which the funds are granted and are available until expended. Mandatory Funds for States that do not request Matching Funds are available until expended.

- Both the Federal and non-Federal share of the Matching Fund shall be obligated in the fiscal year in which the funds are granted and liquidated no later than the end of the succeeding fiscal year.

- For purposes of the CCDF, funds for child care services provided through a child care certificate will be considered obligated when a child care certificate is issued to a family in writing that indicates: the amount of funds that will be paid to a child care provider or family, and the specific length of time covered by the certificate, which is limited to the date established for redetermination of the family's eligibility, but shall be no later than the end of the liquidation period.

- Any funds not obligated during the obligation period specified in paragraph (d) of this section will revert to the Federal government. Any funds not liquidated by the end of the applicable liquidation period specified in paragraph (d) of this section will also revert to the Federal government.

Condition:

During our procedures performed over period of availability we noted Education records subrecipient contracts payments essentially on a cash basis into the program year (e.g., work phase) that is open at the time the payment request is submitted. If the contract payment relates to the prior year work phase but it has been closed they record the encumbrance in the next year work phase that is open. This method of recording contract encumbrances increases the risk that material encumbrances would be recorded and thus reported in the improper period, which could also cause non-compliance with liquidation guidelines. In our sample of 50 payments made, we noted 9 of the 50 where the service period did not coincide with the Federal fiscal year recorded due to this methodology.

- 3 of the 9 exceptions had a service period beginning before the 1st day to obligate program funds in the Federal fiscal year recorded. The estimated total incurred before the 1st day to obligate totaled $11,197,738. The exceptions were as follows:

  – Contract advance for $1,000,000 with a service period from June 15, 2003 through January 31, 2005 was recorded into the Federal fiscal year 2003 award where the 1st day to obligate was October 1, 2003.

  – Contract advance for $6,302,702 with a service period July to November 2005 was recorded into the Federal fiscal year 2005 award where the 1st day to obligate was October 1, 2005.

- Contract advance for $12,042,013 with a service period from July to November 2005 was recorded into the Federal fiscal year 2005 award where the 1st day to obligate was October 1, 2005.

- 6 of the 9 exceptions were encumbered during the obligation period, however, the service period and contract execution date is past the last day to obligate program funds. The estimated total incurred after the last day to obligate totaled $513,850. The exceptions were as follows:

  - Contract advances totaling $1,894,407 with service periods from July to October 2005 were recorded into the Federal fiscal year 2004 award where the last day to obligate was September 30, 2005.

We also noted 4 of the 50 sample payments to subrecipient contractors were paid after the last date to liquidate funds. All four sample items totaling $89,044 were recorded in the Federal fiscal year 2003 award, which was appropriate for the June 2004 service period: however, the payments were made on October 31, 2005 and December 12, 2005 and the last day to liquidate obligations was September 30, 2005.

Questioned Costs:

$11,800,632 of the $59,621,026 sampled ($11,711,588 recorded in improper period + $89,044 paid after last day to liquidate)

Recommendations:

We recommend that Education enhance its current polices and procedures to ensure that payments made to subrecipient contractors are recorded in the corresponding Federal fiscal award year when the services are provided and any liquidations of obligations are made in a more timely manner.

Department's View and Corrective Action Plan:

Education will enhance policies and procedures to ensure that payments to subrecipients for services provided are made in the corresponding Federal fiscal award year, and that obligations are liquidated in a timely manner. Specifically, Education is developing a list that provides the necessary information to ensure expenditures are recorded against the correct federal grant year. Beginning with the state fiscal year 2007-08, each pay-run will contain a list of subrecipients that are being reimbursed for multiple service months and identify services by quarter.

Reference Number:	2006-8-4
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster—Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Number and Calendar Year Awarded:	G-0301CACCDF; 2003

Category of Finding: Period of Availability

State Administering Department: Department of Education (Education)

Criteria:

TITLE 45—HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.20 Standards for financial management systems:

- A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds.

- Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors must be sufficient to permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

TITLE 20—EDUCATION, CHAPTER 31—GENERAL PROVISIONS CONCERNING EDUCATION, SUBCHAPTER II—APPROPRIATIONS AND EVALUATIONS, Part 1—Appropriations, Section 1225. Availability of appropriations on academic or school- year basis; additional period for obligation of funds, (b) Succeeding fiscal year

- Notwithstanding any other provision of law, unless enacted in specific limitation of the provisions of this subsection, any funds from appropriations to carry out any programs to which this chapter is applicable during any fiscal year, which are not obligated and expended by educational agencies or institutions prior to the beginning of the fiscal year succeeding the fiscal year for which such funds were appropriated shall remain available for obligation and expenditure by such agencies and institutions during such succeeding fiscal year.

- Any funds under any applicable program which, pursuant to paragraph (1), are available for obligation and expenditure in the year succeeding the fiscal year for which they were appropriated shall be obligated and expended in accordance with:

  – the Federal statutory and regulatory provisions relating to such program which are in effect for such succeeding fiscal year, and

  – any program plan or application submitted by such educational agencies or institutions for such program for such succeeding fiscal year.

Condition:

During our procedures performed over period of availability, we reviewed the general ledger for any adjusting journal entries made during the fiscal year and noted twelve adjusting entries totaling $6,776,681 were recorded to transfer expenditures of funds between different grant award years. We reviewed Education's process for approval of these journal entries and noted Education does not maintain support for the adjusting entries which include the specific transactions that were actually transferred. Rather, the journal entry process approval consists of a review of the totals of pools of funds that it believes meet the criteria to be transferred to a different fiscal year. Upon further follow up Education was able to reproduce support to the level of detail to enable tests to be performed to ascertain if these transactions that were adjusted occurred during the proper period of availability.

Previous correspondence with the Federal Department of Education regarding exceptions noted in prior year audits indicated that unambiguous support should be maintained to support the first-in, first-out (FIFO) close out journal entries, "To the extent that a recipient relies on principles of FIFO accounting, the recipient must also establish that such a method has been consistently used from year to year and must document clearly and unambiguously that the transactions giving rise to the obligations in question arose before the relevant Tydings cutoff date." Without this unambiguous detailed support that identifies specific transactions to support that they were incurred during the proper period transferred, the reviewer cannot verify that transactions are being transferred between the appropriate grant award years.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education enhance its current polices and procedures to ensure appropriate documentation is attached to all closeout FIFO journal entries to adequately support specific transactions that are being transferred between grant periods so that appropriate review and approval can be made.

Department's View and Corrective Action Plan:

To ensure proper review and approval, Education has implemented procedures requiring the retention of the appropriate documentation to support FIFO expenditure transfers.

Reference Number:	2006-12-2
Federal Catalog Number:	93.767
Federal Program Title:	State Children's Insurance Program
Federal Award Number and Calendar Year Awarded:	05-05A5CA5021; 2005, 05-06A5CA5021; 2006
Category of Finding:	Reporting
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS–Subpart C—Post-Award Requirements, Section 92.20 Standards for financial management systems. Financial Administration

- Financial reporting. Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

- Accounting records. Grantees and subgrantees must maintain records which adequately identify the source and application of funds provided for financially assisted activities. These records must contain information pertaining to grant or subgrant awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income.

Condition:

Health Services does not ensure that amounts reported on its *Quarterly Children's Health Insurance Program Statement of Expenditures for Title XXI 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 and second quarter reports for fiscal year 2005–06 revealed that Health Services was unable to provide supporting documentation for amounts totaling $108,350 and $922,422, respectively, which were reported in the Outpatient Hospital Category.

Health Services states that 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.

Questioned Costs:

Not determined

Recommendations:

We recommend Health Services 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:

Health Services agrees with the recommendation. Health Services has been meeting with Electronic Data Systems (EDS) staff for the past several months in an attempt to determine the underlying issues with the Children's Medical Services (CMS) 21 report. It has been determined that the manual process utilized by accounting for the CMS 21 reporting does not provide enough flexibility to categorize the EDS financial reports by category of service. The automated CMS 64 process provides accounting with program expenditures by category of service. Fiscal Intermediary—Information Technology Management Branch (FI-ITMB) and accounting staff will determine if the CMS 21 reporting process can utilize the existing automated CMS 64 system logic and processes, thus providing accounting with the program expenditures by category of services. Accounting and FI-ITMB will work together to craft a System Development Notice (SDN) to automate some, if not all, of the manual processes used to generate the CMS 21 report. The SDN will ensure that accounting receives the data in a format that will allow reconciliation of program expenditures and accurate reporting by category of service as required.

Reference Number:	2006-12-3
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster—Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund

Federal Award Number and Calendar Year Awarded:	0301CACCDF; 2003
Category of Finding:	Reporting
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 98—CHILD CARE AND DEVELOPMENT FUND—Subpart G—Financial Management, Section 98.67 Fiscal requirements.

Fiscal control and accounting procedures shall be sufficient to permit:

- Preparation of reports required by the Secretary under this subpart and under subpart H; and
- The tracing of funds to a level of expenditure adequate to establish that such funds have not been used in violation of the provisions of this part.

Condition:

During procedures performed over reporting where Education reported their compliance with various matching, level of effort and earmarking requirements, we noted Education performs a manual process to compile the data that is reported on the U.S. Department of Health and Human Services Administration for Children and Families Child Care and Development Fund ACF—696 Financial Report. In our review of the final report for 2003, which ended on September 30, 2005, we noted one error made in the computation and one instance where Education did not maintain supporting documentation for a number reported, as follows:

- In order to compile the State Share of Expenditures, which is reported on a September 30th fiscal year end, Education uses the expenditures for the fiscal year ended June 30th and extracts detailed expenditure reports from the general ledger for the 1st quarter of the prior and current fiscal year based on batch dates and manually performs adjustments on a spreadsheet. We noted expenditures of $135,682 that were erroneously included in the adjustment of the 1st quarter of the prior year, causing an understatement of the State Share of Expenditures. Although this error was not material to the September 30, 2005 report nor did it cause noncompliance of Education's level of effort requirements, this manual process presents a higher risk of material errors being reported without a thorough detail review process.
- Education did not maintain supporting documentation for the non-direct services (local administration and other related child care expenditures) of $124,409,392 that was reported in the CCDF Discretionary Fund. Per further inquiry, the data is generated from Education's PARIS system at a point in time and cannot be recreated.

By not maintaining supporting documentation for required reporting, Education is not in compliance with Federal reporting requirements.

Questioned Costs:

Not determined

Recommendations:

We recommend that Education enhance its current policies and procedures and investigate more possible automated process to compile reporting data and perform a detailed review to reduce the risk of material inaccurate reporting. Also, maintain all supporting documentation for required reporting for the required document retention period.

Department's View and Corrective Action Plan:

Education will retain quarterly reports for the required retention period to support the non-direct expenditures for local administration and other related child care costs.

Reference Number:	2006-12-4
Federal Catalog Number:	93.778
Federal Program Title:	Medicaid Cluster: Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	5-0505CA5048; 2005, 5-0605CA5048; 2006
Category of Finding:	Reporting
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 431—STATE ORGANIZATION AND GENERAL ADMINISTRATION, Subpart A Single State Agency, Section 431.17 Maintenance of records.

- Content of records. A state plan must provide that the Medicaid agency will maintain or supervise the maintenance of the records necessary for the proper and efficient operation of the plan. The records must include:
  - Statistical, fiscal, and other records necessary for reporting and accountability as required by the Secretary.

Condition:

The federal expenditures noted in the quarterly CMS-64, *Quarterly Statement of Expenditures for the Medical Assistance Program*, reports are not traceable to individual claims.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Health Services implement an audit trail such that funding sources for individual claims may be identified.

Department's View and Corrective Action Plan:

The expenditures in the CMS-64 reports are not traceable to individual claims. This is correct. Health Services agrees with the recommendation that the CMS-64 system (the system) should have an audit trail to individual claims. The purpose of the system is to meet the report summary needs for the Health Services accounting section. The system was designed to calculate the federal funding participation (FFP) for programs administered by Health Services. It does this by importing the CA-MMIS weekly checkwrite data into CMS-64, which is organized by service and aid categories codes. The payments systems division will submit a Systems Development Notice to redesign the system to incorporate the capability to trace summary reports that are submitted to CMS and the California State Accounting and Reporting System (CALSTARS), back to individual claims. It will be a significant design change to both mainframe and non-mainframe applications. Due to the substantial scope of this change, and the resources needed to achieve the objectives, the estimated completion date for this project will be approximately January of 2009.

Reference Number:	2006-13-12
Federal Catalog Number:	93.917
Federal Program Title:	HIV Care Formula Grants
Federal Award Number and Calendar Year Awarded:	6X07HA00041-15-02; 2005
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions,

(f) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity's financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditors' reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of:

- 30 days after receipt of the auditors' report; or
- 9 months after the end of the period audited, or within a longer timeframe authorized by the Federal agency, determined under criteria issued under Section 7504, when the 9-month timeframe would place an undue burden on the non-Federal entity.

Condition:

During our procedures performed over subrecipient monitoring, we noted that Health Services was unable to locate the A-133 audit report for one of the four community based organizations (CBOs) selected for test work for the Care Services Program (CSP). We also found that one of the 15 CBOs from the Case Management Program (CMP) had not submitted their A-133 report. Health Services had not taken appropriate actions to ensure that all subrecipients comply with Federal A-133 single audit requirements.

Questioned Costs:

Not determined

Recommendations:

Health Services should strengthen controls to ensure appropriate receipt of A-133 reports and impose sanctions as necessary.

Department's View and Corrective Action Plan:

Health Services generally agrees with the recommendation to strengthen controls to ensure that, for those subrecipients who do not submit their A-133 reports within the required timeframes, A-133 single audit reports are received within the required timeframes. Health Services will continue to closely monitor audit responses using appropriate tracking tools.

Reference Number:	2006-13-13
Federal Catalog Number:	93.268
Federal Program Title:	Immunization Grants
Federal Award Numbers and Calendar Years Awarded:	H23/CCH922507-04-1; 2006 H23/CCH922507-03-5; 2005
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions:

- Each pass-through entity shall:
  - Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;
  - Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and
- The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity's financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor's reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of:
  - 30 days after receipt of the auditor's report; or
  - 9 months after the end of the period audited, or within a longer timeframe authorized by the Federal agency, determined under criteria issued under Section 7504, when the 9-month timeframe would place an undue burden on the non-Federal entity.

Condition:

Health Services does not have adequate controls in place to identify and obtain A-133 reports from subrecipients expending $500,000 or more in federal funds. Without an effective system to identify subrecipients required to have audits and to track the timely receipt of these required audit reports, Health Services has reduced assurance that its subrecipients are spending federal assistance according to applicable laws and regulations.

Questioned Costs:

Not determined

Recommendations:

Health Services should establish procedures to identify those subrecipients required to submit audit reports and should obtain audit reports from them in a timely manner. We understand that Health Services has subsequently implemented procedures to ensure compliance with this requirement.

Department's View and Corrective Action Plan:

Health Services concurs with the finding and recommendation. Health Services has updated contract language to notify subrecipients of their responsibility to submit annual audits. Health Services has also drafted communications to remind subrecipients of this requirement and has put check points in place to ensure that audit reports are received and reviewed in a timely manner.

Reference Number:	2006-13-14
Federal Catalog Numbers:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster: Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Number and Calendar Year Awarded:	G-0501CACCDF; 2005
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;
- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;
- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and;
- Require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient's records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.40 Monitoring and reporting program performance, (a) Monitoring by grantees:

- Grantees are responsible for managing the day-to-day operations of the grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

During procedures performed over subrecipient monitoring, we noted the Child Care Development Fund program Local Educational Agencies (LEAs) are monitored by the Consolidated Program Monitoring (CPM) unit of Education and the non-LEA contractors are monitored by the Contract Monitoring Review (CMR) team. The CPM unit performs program monitoring site reviews on its subrecipients, where Education selects a subrecipient and monitors a number of its larger programs. We selected a sample of schools that had been monitored by CPM and reviewed the documentation retained to support the review's findings and conclusions and noted the following:

- Documentation of the monitoring visit is evidenced by the *Cross-Program Instrument* (CP). This CP is the only official documentation that is retained to support the procedures performed during the monitoring visit. The program does not retain detail work paper documentation of the samples tested, interviews performed, etc. to support the conclusions reached.

- The monitoring procedures contained limited fiscal procedures and should be enhanced to cover all major functions and activities of the program.

- There was no documented signoff of approval for the procedures performed and conclusions reached for the monitoring visit on the CP by someone other than the preparer.

By not maintaining adequate documentation of the procedures performed or ensuring that appropriate reviews and approvals are performed, Education is not able to adequately support conclusions reached during its monitoring visits.

We also selected a sample of 25 subrecipients that had been monitored by the CMR during 2006 and noted there was no evidence of follow up for 9 of the 25 reports with findings. We also noted there was no signature of the agency representative on the report issued for 4 of the 25 samples, which is a required step of the unit's required procedures. Nontimely follow up of monitoring findings increases the risk that those findings will be repeated in future years causing prolonged noncompliance.

Since the majority of program funds are passed through to subrecipients, there is an increased need for strong subrecipient monitoring procedures to reduce the risk of potential material noncompliance by its subrecipient contractors.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over subrecipient monitoring, specifically the during-the-award monitoring (i.e., monitoring visits), to ensure that sufficient documentation is retained in enough detail to support the conclusions reached and that there is evidence that this documentation is reviewed by someone other than the preparer before final reports are issued.

We also recommend Education enhance the extent of the monitoring procedures performed or documentation maintained to support tests of fiscal elements (i.e., sampling expenditures from the general ledger to test for allowability, etc.) to support they are being adequately reviewed and to ensure that these monitoring procedures cover each program, function, and activity of the LEA that

is sampled. This additional documentation of procedures will support Education's assertions that its subrecipients are complying with program laws, regulations, and grant award provisions and that its performance goals and objectives are being achieved.

Department's View and Corrective Action Plan:

Education will strengthen procedures over subrecipient monitoring by requiring reviewers to notate in more detail the documents or evidence used to support the conclusions on the site visitation form. With regard to testing fiscal elements, Education follows up on information reported by the LEA's independent certified public accountant's A-133 single audit reports. Additionally, Education follows up on any fiscal concerns identified in other subrecipient monitoring reviews (e.g., categorical program monitoring and contract monitoring reviews). If more extensive fiscal procedures are deemed necessary, Education's Audits and Investigations Division can be requested to assist in determining an LEA's compliance with required fiscal elements.

Auditors' Comment on Department's View and Corrective Action Plan:

The Auditor believes that Education's view of placing significant reliance on subrecipient A-133 audits does not adequately address the risk of material noncompliance of all programmatic and fiscal requirements by its LEAs. Education should consider the complexity of the requirements and the risk that LEAs may not assess compliance correctly. Education, as a pass through entity, is responsible to provide technical advice to the LEAs and auditors of those LEAs, testing key fiscal elements is a valuable tool to assess the understanding of those requirements. Information obtained during its sampled LEAs monitoring visits can then be used to develop more effective guidance to LEAs to assist in complying with required rules and regulations.

Its comment regarding following up on fiscal concerns identified in other monitoring reviews is not applicable, since the condition of the finding indicates the inadequacy of those specific monitoring review procedures that Education indicated where it would follow up.

The Department's view and corrective action plan does not address the recommendation regarding the review and approval of the monitoring reports issued by Education. A documented supervisory review is a valuable control to help ensure that the conclusions reached in the report are adequately supported.

Reference Number:	2006-13-15
Federal Catalog Number:	93.575 & 93.596
Federal Program Title:	Child Care Development Fund Cluster—Child Care and Development Block Grant & Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Number and Calendar Year Awarded:	G-0601CACCDF; 2006
Category of Finding:	Subrecipient monitoring
State Administering Department:	Department of Education (Education)

Criteria:

TITLE 45—PUBLIC WELFARE, SUBTITLE A—DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 92—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE, LOCAL, AND TRIBAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 92.26 Non-Federal audit.

(a) Basic rule. Grantees and subgrantees are responsible for obtaining audits in accordance with the Single Audit Act Amendments of 1996 (31 U.S.C. 7501-7507) and revised OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.* The audits shall be made by an independent auditor in accordance with generally accepted *Government Auditing Standards* covering financial audits.

(b) Subgrantees. State or local governments, as those terms are defined for purposes of the Single Audit Act Amendments of 1996, that provide Federal awards to a subgrantee, which expends $300,000 or more (or other amount as specified by OMB) in Federal awards in a fiscal year, shall:

- Determine whether State or local subgrantees have met the audit requirements of the Act and whether subgrantees covered by OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*, have met the audit requirements of the Act. Commercial contractors (private for-profit and private and governmental organizations) providing goods and services to State and local governments are not required to have a single audit performed. State and local governments should use their own procedures to ensure that the contractor has complied with laws and regulations affecting the expenditure of Federal funds;

- Determine whether the subgrantee spent Federal assistance funds provided in accordance with applicable laws and regulations. This may be accomplished by reviewing an audit of the subgrantee made in accordance with the Act, Circular A-110, or through other means (e.g., program reviews) if the subgrantee has not had such an audit;

- Ensure that appropriate corrective action is taken within six months after receipt of the audit report for an instance of noncompliance with Federal laws and regulations;

Condition:

During procedures performed over subrecipient monitoring, we noted the A-133 single audits of the subrecipient Local Educational Agencies (LEAs) are initially collected by the State Controller's Office who ensures the completeness and timeliness of all LEA reports. The LEA reports are simultaneously sent to Education to address the findings and recommendations noted. Education maintains a central department entitled Management Assistance, Categorical Programs and Audit Resolution that is responsible for addressing and resolving findings noted in the A-133 reports. The data from these reports is entered into a central database to track the status of findings and recommendations.

- Education relies upon this database as its sole tracking device for subrecipent audit findings that need to be addressed by Education. There does not appear to be adequate segregation of duties or an independent review process by the consultants who are responsible for the database. The A-133 reports are input into the database by the consultants; however the review of the data input is checked by the same consultant who performed the input. There is no independent review of the database information by the department administrator to assess its accuracy or completeness.

- There is no formal report generated from the database to be reviewed by Education management that summarizes the status of the LEAs findings that are required to have Education management decisions issued within 6 months after receipt of the report. This information is needed by management to adequately monitor the audit finding resolution process being performed by its consultants to ensure timeliness of the management decisions required to be made. Of the 50 June 30, 2005 A-133 LEA reports sampled, we noted 12 LEAs with audit findings that required Education management decisions. Of those 12 LEAs requiring management decisions, we noted 2 with unresolved findings outstanding after 10 months and two additional LEAs with findings resolved later than 6 months after the receipt of the report.

- Findings are resolved with the LEAs by the consultants in the Management Assistance, Categorical Programs and Audit Resolution, unit. We noted some informal e-mail communications discussing some of the findings contained in the reports, however there is no formal notification from the Audit Resolution Department to the respective Education program departments or Consolidated Performance Monitoring Unit nor are copies of any audit resolution correspondence forwarded to the respective program department regarding the A-133 single audit findings of its subrecipients. This information is important to the program departments to assist in the development of their monitoring procedures to be performed over its program subrecipients. With this information the program department could more accurately determine subrecipient risk and focus its monitoring efforts on higher risk LEAs that either had audit findings or did not have its program audited as a major program in the last year or last several years.

Without appropriately designed segregation of duties and formal checks, balances and communications, Education risks that noncompliance noted in subrecipient A-133 audits are not being timely addressed in accordance with Federal regulations.

Questioned Costs:

Not applicable

Recommendations:

We recommend that Education strengthen its current policies and procedures over its A-133 audit finding resolution process by formalizing communications and resolutions. The files should contain formal evidence of input, reviews and approvals that supports the timing, agreement with the proposed corrective action, and notification of the respective program department.

We also recommend that Education generate a periodic status of findings and corrective actions for review by the audit resolution department administrator to assist in monitoring the timeliness of Education's resolution of audit findings.

We further recommend that Education disseminate the information obtained from the A-133 reports captured in the database (i.e., number of LEAs with ChildCare audited as a major program, identification of findings for ChildCare program, etc.) to the appropriate program staff and consolidated program monitoring unit to assist in the determination of subrecipient risk, which is an important component of determining the extent of monitoring procedures that should be performed on specific LEAs.

Department's View and Corrective Action Plan:

To assist in monitoring the timeliness of an LEA's resolution of audit findings, Education will disseminate a summary report of A-133 audit findings to respective program staff. Additionally, Education will provide a status report of A-133 audit findings to the administrator of the Audit Resolution Unit for review, approval, and to manage the resolution of A-133 audit findings.

Reference Number:	2006-14-1
Federal Catalog Number:	93.777
Federal Program Title:	Medicaid Cluster: State Survey and Certification of Health Care Providers and Supplies
Federal Award Number and Calendar Year Awarded:	05-0505CA5000; 2005, 05-0605CA5000; 2006
Category of Finding:	Special Tests and Provisions, Provider Eligibility
State Administering Department:	Department of Health Services (Health Services)

Criteria:

TITLE 42—PUBLIC HEALTH, CHAPTER IV—CENTERS FOR MEDICARE & MEDICAID SERVICES, DEPARTMENT OF HEALTH AND HUMAN SERVICES, PART 431—STATE ORGANIZATION AND GENERAL ADMINISTRATION, Subpart C, Administrative Requirements: Provider Relations, Section 431.107 Required provider agreement. (b) Agreements.

- A state plan must provide for an agreement between the Medicaid agency and each provider or organization furnishing services under the plan in which the provider or organization agrees to:

  (1) Keep any records necessary to disclose the extent of services the provider furnishes to recipients;

  (2) On request, furnish to the Medicaid agency, the Secretary, or the State Medicaid fraud control unit (if such a unit has been approved by the Secretary under Section 455.300 of this chapter), any information maintained under paragraph (b)(1) of this section and any information regarding payments claimed by the provider for furnishing services under the plan;

  (3) Comply with the disclosure requirements specified in part 455, subpart B of this chapter; and

Condition:

Of the sample providers tested, 25 of the 50 did not have a Provider Agreement on file at the Provider Eligibility Branch and License & Certification Unit. This is a repeat finding from prior years.

Questioned Costs:

Not determined

Recommendations:

We recommend that Health Services strengthen controls to retain all provider agreements and continue its re-enrollment process to ensure that it obtains the appropriate certifications, agreements, and disclosures.

Department's View and Corrective Action Plan:

Health Services concurs with the recommendation that it should continue its re-enrollment process to ensure that it obtains all required certifications, agreements, and disclosures.

The auditor's review indicates that four files at the Provider Enrollment Branch did not have a Provider Agreement. Four files did not contain these documents, as they did not exist as separate forms at the time these applicants were initially enrolled in 1995 and 1998.

As part of Health Services' 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 continues to work in conjunction with Audits and Investigations (A&I) to re-enroll providers identified as high risk using an on-going risk assessment analysis and the annual Medi-Cal Payment Error Study (MPES) to prioritize these providers for re-enrollment. Currently, Health Services is completing the re-enrollment of optometrists and several phases are underway to re-enroll identified high-risk physicians and physician groups.

The remaining 21 files identified in this finding are non-long term care providers under the purview of the Licensing and Certification Division (L&C). L&C is underway in modifying the Medi-Cal Participation Agreement for long-term care facilities to apply to non-long term care facilities, by incorporating provisions of the Medi-Cal Provider Agreement (DHS 6208). When this is completed and has cleared legal review, L&C will implement the new agreement for all non-long term care facilities it certifies. L&C estimates completion of this implementation to be in October 2007, to concur with the issuance of new long-term care provider agreements under the aegis of the new California Department of Public Health.

L&C respectfully notes, however, that the absence of provider agreements for non-long term care facilities does not mean the program is unable to ensure that Medi-Cal payments are made only to eligible health facilities, as indicated in the prior audit findings. Under Federal and State Regulations, all non-long term care facilities under the purview of L&C must be preapproved by the U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services (CMS) as eligible for Medicare reimbursement in order to participate in Medi-Cal. Therefore, through the program's periodic on-site health inspections and approval documentation received from CMS, L&C reasonably ensures eligibility of all non-long term care facilities it certifies for Medi-Cal participation.

U.S. DEPARTMENT OF HOMELAND SECURITY

Summary of Findings and Questioned Costs
June 30, 2006

Reference Number:	2006-7-3
Federal Catalog Number:	97.004
Federal Program Title:	State Domestic Preparedness Equipment Support Program
Federal Award Number and Calendar Year Awarded:	2004-GE-T4-0045; 2004
Category of Finding:	Earmarking
State Administering Department:	Governor's Office of Homeland Security (Homeland Security) Governor's Office of Emergency Services (Emergency Services).[1]

CRITERIA:

TITLE 42—THE PUBLIC HEALTH AND WELFARE, CHAPTER 46—JUSTICE SYSTEM IMPROVEMENT, SUBCHAPTER I—OFFICE OF JUSTICE PROGRAMS, Section 3714. Grant program for State and local domestic preparedness support, (c) Authorization of appropriations, (2) Limitations:

Of the amount made available to carry out this section in any fiscal year not more than 3% may be used by the Attorney General for salaries and administrative expenses.

Additionally, the grant agreement for 2004-GE-T4-0045;2004 states that no more than 3% of the total amount allocated to the State for each program may be used for management and administrative purposes. Further, any portion of the 3% retained by the State must be included within the 20% of the total funds to the State.

Condition:

Homeland Security and Emergency Services did not adequately monitor the level of administrative expenditures of funds for the State Domestic Preparedness Equipment Support Program for the fiscal year ended June 30, 2006. According to the Assistant Deputy Director of Grants Management, Emergency Services has expended approximately 15.25% or $12.9 million of the $84.6 million of total cumulative expenditures through June 30, 2006 on administrative costs. This amounts to an over expenditure of $10.4 million of administrative costs as of June 30, 2006. Per review of the grant adjustment notice dated June 24, 2005 and subsequent communications, the grant expenditure period was extended through spring 2007. However, even if the remaining $90.8 million is expended 100% on local assistance, the grant has exceeded its earmarking limit by approximately $7.6 million.

[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.

Emergency Services believes the excessive administrative expenditures were caused by incorrectly coding expenditures between local assistance and administration, which resulted in it exceeding the earmarking requirement.

Questioned Costs:

Not determined

Recommendations:

We recommend Homeland Security and Emergency Services develop processes and controls to track state operations (administrative costs) expenditures separately to determine that the 3% threshold is not exceeded. In addition, Homeland Security should track the breakout of expenditures relating to local assistance and state operations.

Department's View and Corrective Action Plan:

Homeland Security and Emergency Services concur with the recommendation. Emergency Services has put into place an accounting process of checks and balances to ensure that payments are properly coded and charged to the appropriate programmatic areas. In this process, Emergency Services has implemented protections for the future by changing the process. In addition, Emergency Services has begun an audit process of prior practices to determine any erroneous charges that may have contributed to the finding. These actions will bring us into overall compliance and will ensure that the 3% maximum allowance of the total grant is not exceeded.

Reference Number:	2006-9-1
Federal Catalog Number:	97.039
Federal Program Title:	Hazard Mitigation Grants
Federal Award Number and Calendar Year Awarded:	FEMA-1498-DR, 2003, FEMA-1529-DR, 2004 FEMA-1505-DR, 2004
Category of Finding:	Procurement, Suspension and Debarment
State Administering Department:	Governor's Office of Emergency Services (Emergency Services)

Criteria:

TITLE 44—EMERGENCY MANAGEMENT AND ASSISTANCE, CHAPTER I—FEDERAL EMERGENCY MANAGEMENT AGENCY, DEPARTMENT OF HOMELAND SECURITY, PART 13—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 13.35 Subawards to debarred and suspended parties.

Grantees and subgrantees must not make any award or permit any award (subgrant or contract) at any tier to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549, *Debarment and Suspension*.

Condition:

During procedures performed over suspension and debarment of subrecipients, we noted Emergency Services utilizes a *Project Application for Federal Assistance Form (Form 89)* for its subrecipients participating in the Hazard Mitigation Grant Program (HMGP). The latest revision of Form 89 implemented in January 2005 includes the appropriate required language for the subrecipient to certify that they have not been suspended or debarred from participating in a Federally funded program. However, we noted HMGP did not require 18 of the 30 subrecipients we reviewed who received grant awards prior to January 2005 to complete an updated Form 89 that contained the required certifications, nor did it review the Federal excluded parties list system (EPLS) website to verify that the subrecipient was neither suspended or debarred. The prior noncompliant Form 89 was carried forward into the subrecipients' new projects. Consequently, there are no signed certifications on file for those subrecipients of the HMGP.

Questioned Costs:

Not determined

Recommendation

We recommend that Emergency Services ensure adequate policies, procedures, and documentation exist to support verification that subrecipients are not suspended or debarred before awarding program funds by querying the EPLS, collecting a certification from the other party, or adding a clause or condition to the covered transaction with that party.

Department's View and Corrective Action Plan:

Emergency Services concurs with the finding and has implemented the following corrective actions:

1. The Hazard Mitigation Branch will be revising the List of Assurance (Form 89) for the HMGP to add the following:

   As the duly authorized representative of the applicant, I certify that the applicant: Is not debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549 and 12689, "Debarment and Suspension" and will not make any award or permit any award (subgrant or contract) to any party which is debarred or suspended or is otherwise excluded from or ineligible for participation in Federal assistance programs under Executive Order 12549 and 12689, *Debarment and Suspension*.

2. HMGP Application Process Change:

   Emergency Services as the Grantee, will have each approved subgrantee sign a new List of Assurance (2007 rev. Form 89) with the initial obligation for each subgrant (no longer allowing the use of a "Universal" Form 89) and will revise the Standard Operating Procedures for processing HMGP applications accordingly.

Reference Number: 2006-12-1

Federal Catalog Number: 97.036

Federal Program Title:	Disaster Grants—Public Assistance (Presidentially Declared Disasters) Hazard Mitigation Grants Program
Federal Award Number and Calendar Year Awarded:	FEMA-845-DR; 1989 FEMA-3120-EM; 1996 FEMA-919-DR; 1991 FEMA-1203-DR; 1998 FEMA-935-DR; 1992 FEMA-1498-DR; 2003 FEMA-942-DR; 1992 FEMA-1505-DR; 2004 FEMA-943-DR; 1992 FEMA-1529-DR; 2004 FEMA-947-DR; 1992 FEMA-1577-DR; 2005 FEMA-979-DR; 1993 FEMA-1585-DR; 2005 FEMA-1005-DR; 1993 FEMA-3140-EM; 1999 FEMA-1008-DR; 1994 FEMA-3248-EM; 2005 FEMA-1044-DR; 1995 FEMA-1628-DR; 2006 FEMA-1046-DR; 1995 FEMA-1646-DR; 2006 FEMA-1155-DR; 1996

Federal Catalog Number:	97.039
Federal Program Title:	Hazard Mitigation Grant
Federal Award Number and Calendar Year Awarded:	FEMA-845-DR; 1989 FEMA-1155-DR; 1996 FEMA-872-DR; 1990 FEMA-1203-DR; 1998 FEMA-919-DR; 1991 FEMA-1267-DR; 1999 FEMA-935-DR; 1992 FEMA-1342-DR; 2000 FEMA-942-DR; 1992 FEMA-1498-DR; 2003 FEMA-943-DR; 1992 FEMA-1505-DR; 2004 FEMA-947-DR; 1992 FEMA-1529-DR; 2004 FEMA-979-DR; 1993 FEMA-1577-DR; 2005 FEMA-1005-DR; 1993 FEMA-1585-DR; 2005

FEMA-1008-DR; 1994
FEMA-3248-EM; 2005
FEMA-1044-DR; 1995
FEMA-1628-DR; 2006
FEMA-1046-DR; 1995
FEMA-1646-DR; 2006

Category of Finding: Reporting

State Administering Department: Governor's Office of Emergency Services (Emergency Services)

Criteria:

TITLE 44—EMERGENCY MANAGEMENT AND ASSISTANCE, CHAPTER I—FEDERAL EMERGENCY MANAGEMENT AGENCY, DEPARTMENT OF HOMELAND SECURITY, PART 13—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 13.20 Standards for financial management systems. Financial Administration

A State must expend and account for grant funds in accordance with State laws and procedures for expending and accounting for its own funds. Fiscal control and accounting procedures of the State, as well as its subgrantees and cost-type contractors, must be sufficient to:

- Permit preparation of reports required by this part and the statutes authorizing the grant, and
- Permit the tracing of funds to a level of expenditures adequate to establish that such funds have not been used in violation of the restrictions and prohibitions of applicable statutes.

Condition:

Emergency Services is required to report total recipient and subrecipient nonfederal expenditures and administrative expenses on quarterly Financial Status Reports (FSR), which are submitted to the Federal Emergency Management Agency. In our sample of FSR's selected for the Hazard Mitigation Grant program, we noted 4 of the 18 did not contain all the required expenditure information (FEMA-845-DR; 1989, FEMA-919-DR; 1991 FEMA-979-DR; 1993, and FEMA-1005-DR; 1993). We also noted in our sample of FSR's selected for the Public Assistance Grants Program, 1 of the 23 did not report recipient share of outlays (FEMA-3248-EM; 2005). In addition, none of the FSR samples selected reported subrecipient nonfederal expenditures and administrative expenses.

Emergency Services states it does not currently have a process to capture the nonfederal and administrative expenditures for subrecipients, which causes the incomplete reporting. Emergency Services is out of compliance with the reporting requirement to include all requisite information in the FSR.

Questioned Costs:

Not determined

Recommendation

We recommend that Emergency Services enhance its current procedures to ensure that recipient and subrecipient nonfederal expenditures and administrative expenses are properly reported in the FSR.

Department's View and Corrective Action Plan:

Emergency Services concurs with this finding. California State Accounting and Reporting System (CALSTARS) has functional limitations, which limits our ability to use the accounting system to report the recipient/subrecipient share of outlays. Emergency Services is working on system modifications to its grants tracking system (Automated Ledger System) to track the nonfederal expenditures for reporting purposes for current and future grants and disasters.

Reference Number:	2006-13-3
Federal Catalog Number:	97.036
Federal Program Title:	Disaster Grants—Public Assistance (Presidentially Declared Disasters)
Federal Award Number and Calendar Year Awarded:	FEMA-845-DR; 1989 FEMA-3120-EM; 1996 FEMA-919-DR; 1991 FEMA-1203-DR; 1998 FEMA-935-DR; 1992 FEMA-1498-DR; 2003 FEMA-942-DR; 1992 FEMA-1505-DR; 2004 FEMA-943-DR; 1992 FEMA-1529-DR; 2004 FEMA-947-DR; 1992 FEMA-1577-DR; 2005 FEMA-979-DR; 1993 FEMA-1585-DR; 2005 FEMA-1005-DR; 1993 FEMA-3140-EM; 1999 FEMA-1008-DR; 1994 FEMA-3248-EM; 2005 FEMA-1044-DR; 1995 FEMA-1628-DR; 2006 FEMA-1046-DR; 1995 FEMA-1646-DR; 2006 FEMA-1155-DR; 1996

Federal Catalog Number:	97.039
Federal Program Title:	Hazard Mitigation Grant
Federal Award Number and Calendar Year Awarded:	FEMA-845-DR; 1989 FEMA-1155-DR; 1996 FEMA-872-DR; 1990 FEMA-1203-DR; 1998 FEMA-919-DR; 1991 FEMA-1267-DR; 1999 FEMA-935-DR; 1992 FEMA-1342-DR; 2000 FEMA-942-DR; 1992 FEMA-1498-DR; 2003 FEMA-943-DR; 1992 FEMA-1505-DR; 2004 FEMA-947-DR; 1992 FEMA-1529-DR; 2004 FEMA-979-DR; 1993 FEMA-1577-DR; 2005 FEMA-1005-DR; 1993 FEMA-1585-DR; 2005 FEMA-1008-DR; 1994 FEMA-3248-EM; 2005 FEMA-1044-DR; 1995 FEMA-1628-DR; 2006 FEMA-1046-DR; 1995 FEMA-1646-DR; 2006
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Governor's Office of Emergency Services (Emergency Services)

Criteria:

TITLE 31—MONEY AND FINANCE, SUBTITLE V—GENERAL ASSISTANCE ADMINISTRATION, CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS, Section 7502. Audit requirements; exemptions, (f)(2) Each pass-through entity shall:

- Monitor the subrecipient's use of Federal awards through site visits, limited scope audits, or other means;

- Review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

TITLE 44—EMERGENCY MANAGEMENT AND ASSISTANCE, CHAPTER I–FEDERAL EMERGENCY MANAGEMENT AGENCY, DEPARTMENT OF HOMELAND SECURITY, PART 13—UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND COOPERATIVE AGREEMENTS TO STATE AND LOCAL GOVERNMENTS—Subpart C—Post-Award Requirements, Section 13.40 Monitoring and reporting program performance. (a) Monitoring by grantees.

Grantees are responsible for managing the day-to-day operations of grant and subgrant supported activities. Grantees must monitor grant and subgrant supported activities to assure compliance with applicable Federal requirements and that performance goals are being achieved. Grantee monitoring must cover each program, function or activity.

Condition:

Emergency Services did not adequately monitor its subrecipients of funds for either of its Public Assistance or Hazard Mitigation Grant Program for the fiscal year ended June 30, 2006. According to the chief of its Grants Management Branch, Emergency Services, there is a backlog in performing the reviews and preparing management letters due to lack of staffing. Emergency Services has not reviewed an estimated combined 1,575 audit reports submitted by subrecipients dating back to 2002. In addition, Emergency Services has not followed up with subrecipients who have not submitted their single audit reports. Further, Emergency Services does not have processes or controls in place to accurately track whether subrecipients' audit reports have been submitted or reviewed.

Emergency Services states that it lacks sufficient staff to adequately monitor the receipt of the reports, review them, issue management decisions on the findings contained in them, and ensure that the subrecipients have taken timely and appropriate corrective action on all audit findings. Without performing these procedures, Emergency Services could not ensure that subrecipients were complying with federal program requirements.

Questioned Costs:

Not determined

Recommendations:

We recommend that Emergency Services develop a process to review subrecipient audit reports, respond and resolve findings noted in those reports, and ensure appropriate corrective action is taken within six months after receipt of the subrecipient A-133 audit report in accordance with Federal guidelines.

Department's View and Corrective Action Plan:

Emergency Services concurs with the finding and has implemented corrective action. An audit coordinator was hired in December 2006, and that person's responsibilities include the review of A-133 audit reports and the resolution of any findings in programs administered by Emergency Services. Emergency Services expects to complete the review of all backlogged reports, and be current on newly received reports, by June 30, 2007.

Clifton Gunderson LLP

U.S. ENVIRONMENTAL PROTECTION AGENCY

Bureau of State Audits Reference Number	2006-13-17
Reference Number:	2006-01
Federal Catalog Number:	66.458
Federal Program Title:	Capitalization Grants for Clean Water State Revolving Funds
Category of Finding:	Subrecipient Monitoring
State Administering Department:	State Water Resources Control Board

CRITERIA

Section .400(d) of OMB Circular A-133 requires a pass-through entity to perform the following for the federal awards it makes:

(1) Identify federal awards made by informing each subrecipient of the CFDA title and number, award name and number, award year, if the award is research and development, and name of the federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the federal award.

(2) Advise subrecipients of requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.

(3) Monitor the activities of 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.

(4) Ensure that subrecipients expending $500,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of OMB Circular A-133 for that fiscal year.

(5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely correction action.

(6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

(7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records of financial statements as necessary for the pass-through entity to comply with OMB Circular A-133.

CONDITION

Subrecipients were not notified of all required federal award information pertaining to the federal award as noted in (1) above. Additionally, single audits were not completed or not properly completed by certain subrecipients in accordance with (4) above.

EFFECT

California State Water Resources Control Board, Water Pollution Control Revolving Fund (Fund) is not in compliance with certain pass-through entity responsibilities.

QUESTIONED COSTS

$26,061,094

CONTEXT

Generally, the subrecipients of the federal awards have June 30 year ends, and as a result due to the fiscal year ends and the completion of audits by subrecipients, testing was limited to single audits submitted for the fiscal year ended June 30, 2005. Six of ten subrecipients required to have single audits completed in accordance with OMB Circular A-133 either did not have them completed or the audits were not properly completed. Four of the six did not have a single audit completed and two of the six had single audits completed, however the Capitalization Grant for Clean Water State Revolving Funds (CFDA No. 66.458) was not listed on the Schedule of Expenditures of Federal Awards. Neither the California State Controller's Office or the Fund followed up with the entities regarding the lack of completed single audits or improperly completed single audits for the year ended June 30, 2005. The total federal funds disbursed to the six subrecipients by the Fund for the year ended June 30, 2005 for which no single audit was completed or was improperly completed was $26,061,094. The total reported expenditures of federal awards reported by the Fund on the Schedule of Expenditures of Federal Awards for the year ended June 30, 2005 was $64,450,038, of which $61,005,181 was passed through to subrecipients.

CAUSE

Required federal award information was not included in the loan contracts with subrecipients or otherwise communicated to subrecipients. Additionally, the Water Pollution Control Revolving Fund and the California State Controller's Office have not developed an effective process to ensure that subrecipients receiving federal awards in excess of $500,000 are having single audits completed and submitted when required. Additionally, there is not timely follow-up in instances where single audits are required to be submitted but are not received.

RECOMMENDATION

We recommend the Water Pollution Control Revolving Fund communicate all required federal award identification information in their contracts with subrecipients. Additionally, we recommend that all subrecipients receiving federal awards be notified annually of the amount of federal awards disbursed to them. The subrecipient should also be notified that a single audit is to be completed if

total federal awards received from all sources during the fiscal year exceeded $500,000. The California State Controller Office should be included in this communication so that appropriate follow-up can be performed on the single audits received.

MANAGEMENT RESPONSE AND CORRECTIVE ACTION PLAN

Management agrees with the comment, except for the questioned costs. The management of the Fund has implemented significant review processes regarding the disbursement of federal awards to subrecipients to ensure that federal awards are disbursed for allowable activities and allowable costs. Accordingly, management of the Fund believes this to be a compliance finding with no questioned costs.

Management was aware of this requirement and had already begun notifying all agencies that received more than $500,000 in Federal funds for the year June 30, 2006. Management is following up with the State Controller's Office of California for missing or improperly performed single audits for the years ended June 30, 2005, and 2006. Management of the Fund will develop a method of communicating the required information to subrecipients. Management will also report, on an annual basis, to subrecipients, the amount of Federal awards disbursed to the subrecipients. In addition, management will work in conjunction with the SCO to develop a process to ensure that all subrecipients that are required to have single audits have them completed and forwarded to SCO and the Fund annually. Management will review the single audits timely and issue management decisions on any findings noted the timeframe outlined in OMB Circular A-133.

AUDITEE’S SECTION

Schedule of Federal Assistance

Prepared by
Department of Finance

STATE OF CALIFORNIA
SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2006

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Agriculture		
Agricultural Research Service - Basic and Applied Research	10.001	$ 1,746
Plant and Animal Disease, Pest Control, and Animal Care	10.025	193,167*
Wetlands Reserve Program	10.072	3,900
Market Protection and Promotion	10.163	370,475
Food Donation	10.550	93,078,423*
Special Supplemental Nutrition Program for Women, Infants, and Children	10.557	829,211,277
Child and Adult Care Food Program	10.558	236,699,329
State Administrative Expenses for Child Nutrition	10.560	17,179,259
Commodity Supplemental Food Program	10.565	3,122,831
Nutrition Services Incentive	10.570	67,663
WIC Farmers' Market Nutrition Program (FMNP)	10.572	2,506,772
Team Nutrition Grants	10.574	34,562
Senior Farmers Market Nutrition Program	10.576	504,940
Cooperative Forestry Assistance	10.664	9,199,870
Schools and Roads - Grants to States	10.665	64,609,518
National Forest-Dependent Rural Communities	10.670	4,304
Urban and Community Forestry Program	10.675	127,798
Forest Legacy Program	10.676	114
Forest Land Enhancement Program	10.677	3,228
Environmental Quality Incentives Program	10.912	35,242
Wildlife Habitat Incentive Program	10.914	1,683
Other - U.S. Department of Agriculture	10.999	32,100,832
Total Excluding Clusters		1,289,056,933
Food Stamp Cluster		
Food Stamps	10.551	2,358,515,817*
State Administrative Matching Grants for Food Stamp Program	10.561	418,149,569
Total Food Stamp Cluster		2,776,665,386
Child Nutrition Cluster		
School Breakfast Program	10.553	247,537,942

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
National School Lunch Program	10.555	963,768,416
Special Milk Program for Children	10.556	670,717
Summer Food Service Program for Children	10.559	13,032,848
Total Child Nutrition Cluster		1,225,009,923
Emergency Food Assistance Cluster		
Emergency Food Assistance Program (Administrative Costs)	10.568	7,686,783
Emergency Food Assistance Program (Food Commodities)	10.569	29,698,204*
Total Emergency Food Assistance Cluster		37,384,987
Research & Development Cluster		
Agricultural Research - Basic and Applied Research	10.001	16,314
Plant and Animal Disease, Pest Control, and Animal Care	10.025	565,275
Total Research and Development Cluster		581,589
Total U.S. Department of Agriculture		5,328,698,818
Department of Commerce		
Economic Development-Support for Planning Organizations	11.302	50,000
Anadromous Fish Conservation Act Program	11.405	750,963
Interjurisdictional Fisheries Act of 1986	11.407	139,237
Coastal Zone Management Administration Awards	11.419	5,063,057
Coastal Zone Management Estuarine Research Reserves	11.420	630,214
Pacific Coast Salmon Recovery-Pacific Salmon Treaty Program	11.438	10,814,468
Coastal Services Center	11.473	9,285
Other - U.S. Department of Commerce	11.999	422,179
Total U.S. Department of Commerce		17,879,403
Department of Defense		
Navigation Projects	12.107	51,171
Planning Assistance to States	12.110	465,000
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113	11,776,673

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Military Construction, National Guard	12.400	7,945,410
National Guard Military Operations and Maintenance (O&M) Projects	12.401	49,094,096
National Guard Civilian Youth Opportunities	12.404	3,308,436
Community Economic Adjustment Planning Assistance	12.607	384,968
Community Economic Adjustment Planning Assistance for Joint Land Use Studies	12.610	44,581
Other - U.S. Department of Defense	12.999	2,314,916
Total U.S. Department of Defense		75,385,251
Department of Housing and Urban Development		
Manufactured Home Construction and Safety Standards	14.171	265,363
Community Development Block Grants/State's Program	14.228	35,820,446
Emergency Shelter Grants Program	14.231	6,281,968
Supportive Housing Program	14.235	3,484,509**
HOME Investment Partnerships Program	14.239	92,652,102**
Housing Opportunities for Persons with AIDS	14.241	2,884,736
Equal Opportunity in Housing	14.400	2,188,975
Lead-Based Paint Hazard Control in Privately-Owned Housing	14.900	660,105
Total Excluding Clusters		144,238,204
Section 8 Tenant-Based Cluster		
Section 8 Rental Voucher Program	14.855	3,760,312
Total U.S. Department of Housing and Urban Development		147,998,516
Department of Interior		
Recreation Resource Management	15.225	25,000
National Fire Plan - Wildland Urban Interface Community Fire Assistance	15.228	691,402
Small Reclamation Projects	15.503	115,167
Anadromous Fish Conservation	15.600	97,929
Endangered Species Conservation	15.612	135,365
Coastal Wetlands Planning, Protection and Restoration Act	15.614	87,789

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Cooperative Endangered Species Conservation Fund	15.615	5,330,851
Clean Vessel Act	15.616	2,191,246
Sportfishing and Boating Safety Act	15.622	390,000
Wildlife Conservation and Restoration	15.625	80,668
Landowner Incentive	15.633	109,874
State Wildlife Grants	15.634	289,036
Earthquake Hazards Reduction Program	15.807	65,002
U.S. Geological Survey-Research and Data Collection	15.808	371,409
Historic Preservation Fund Grants-In-Aid	15.904	944,648
Outdoor Recreation-Acquisition, Development and Planning	15.916	6,349,599
Research Information	15.975	722,297
Other - U.S. Department of the Interior	15.999	43,897,922
Total Excluding Clusters		61,895,204
Fish and Wildlife Cluster		
Sport Fish Restoration	15.605	15,357,227
Wildlife Restoration	15.611	10,981,976
Total Fish and Wildlife Cluster		26,339,203
Research and Development Cluster		
Coastal Wetlands Planning, Protection and Restoration Act	15.614	18,848
Total U.S. Department of Interior		88,253,255
Department of Justice		
State Domestic Preparedness Equipment Support Program	16.007	50,492,797
Prisoner Reentry Initiative Demonstration (Offender Reentry)	16.202	111,288
Juvenile Accountability Incentive Block Grants	16.523	4,326,483
Juvenile Justice and Delinquency Prevention-Allocation to States	16.540	6,842,762
Title V-Delinquency Prevention Program	16.548	1,035,885
Part E-State Challenge Activities	16.549	629,856
State Justice Statistics Program for Statistical Analysis Centers	16.550	19,501
National Criminal History Improvement Program (NCHIP)	16.554	1,993,938
National Institute of Justice Research, Evaluation, and Development Project Grants	16.560	1,644,611

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Crime Laboratory Improvement-Combined Offender DNA Index System Backlog Reduction	16.564	1,349,267
Crime Victim Assistance	16.575	45,674,586
Crime Victim Compensation	16.576	11,449,842
Edward Byrne Memorial Formula Grant Program	16.579	16,988,444
Edward Byrne Memorial State and Local Law Enforcement Assistance Discretionary Grants Program	16.580	539,836
Drug Court Discretionary Grant Program	16.585	22,336
Violent Offender Incarceration and Truth in Sentencing Incentive Grants	16.586	50,149,912
Violence Against Women Formula Grants	16.588	12,817,196
Rural Domestic Violence and Child Victimization Enforcement Grant Program	16.589	2,393,294
Local Law Enforcement Block Grant Program	16.592	374,732
Residential Substance Abuse Treatment for State Prisoners	16.593	2,377,522
State Criminal Alien Assistance Program	16.606	85,953,191
Community Prosecution and Project Safe Neighborhoods	16.609	1,025,287
Regional Information Sharing Systems	16.610	5,672,200
Public Safety Partnership and Community Policing Grants (“COPS” Grants)	16.710	3,811,939
Enforcing Underage Drinking Laws Program	16.727	308,249
Protecting Inmates and Safeguarding Communities Discretionary Grant Program	16.735	53,650
Edward Byrne Memorial Justice Assistance Grant Program	16.738	36,125,542
Other - U.S. Department of Justice	16.999	1,007,559
Total Excluding Clusters		345,191,705
Research and Development Cluster		
National Institute of Justice Research, Evaluation, and Development Project Grants	16.560	5,280
Total U.S. Department of Justice		345,196,985
Department of Labor		
Labor Force Statistics	17.002	8,315,918
Compensation and Working Conditions	17.005	557,800
Labor Certification for Alien Workers	17.203	2,222,599
Unemployment Insurance	17.225	4,907,245,997
Senior Community Service Employment Program	17.235	6,676,628

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Trade Adjustment Assistance	17.245	22,460,215
WIA Pilots, Demonstrations, and Research Projects	17.261	633,127
Work Incentives Grant	17.266	2,080,281
Occupational Safety and Health-State Program	17.503	24,302,283
Consultation Agreements	17.504	5,747,024
Mine Health and Safety Grants	17.600	224,201
Disability Employment Policy Development	17.720	635,157
Total Excluding Clusters		4,981,101,230
Employment Services Cluster		
Employment Service/Wagner-Peyser Funded Activities	17.207	100,615,439
Disabled Veterans' Outreach Program (DVOP)	17.801	11,936,001
Local Veterans' Employment Representative Program	17.804	7,305,355
Total Employment Services Cluster		119,856,795
WIA Cluster		
WIA Adult Program	17.258	134,746,725
WIA Youth Activities	17.259	142,411,871
WIA Dislocated Workers	17.260	183,125,577
Total WIA Cluster		460,284,173
Total U.S. Department of Labor		5,561,242,198
Department of Transportation		
Boating Safety Financial Assistance	20.005	3,467,890
Airport Improvement Program	20.106	30,512
Motor Carrier Safety	20.217	12,584,738
National Motor Carrier Safety	20.218	85,420
High Speed Ground Transportation-Next Generation High Speed Rail Program	20.312	143,808
Federal Transit - Metropolitan Planning Grants	20.505	45,395,256
Formula Grants for Other Than Urbanized Areas	20.509	12,513,710
Pipeline Safety	20.700	1,467,255
Interagency Hazardous Materials Public Sector Training and Planning Grants	20.703	932,645
Total Excluding Clusters		76,621,234

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Highway Planning and Construction Cluster		
Highway Planning and Construction	20.205	2,240,110,849**
Federal Transit Cluster		
Federal Transit - Capital Investment Grants	20.500	7,358,162
Highway Safety Cluster		
State and Community Highway Safety	20.600	48,508,282
Alcohol Traffic Safety and Drunk Driving Prevention Incentive Grants	20.601	7,204,368
Total Highway Safety Cluster		55,712,650
Research and Development Cluster		
Formula Grants for Other than Urbanized Areas	20.509	202,039
Total U.S. Department of Transportation		2,380,004,934
Equal Employment Opportunity Commission		
Employment Discrimination-State and Local Fair Employment Practices Agency Contracts	30.002	2,265,200
General Services Administration		
Donation of Federal Surplus Personal Property	39.003	2,164,145***
National Foundation on the Arts and the Humanities		
Promotion of the Arts-Partnership Agreements	45.007	961,000
Grants to States	45.310	17,425,586
Total National Foundation on the Arts and Humanities		18,386,586
Department of Veterans Affairs		
Grants to States for Construction of State Home Facilities	64.005	3,454,714

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Veterans State Domiciliary Care	64.014	9,406,788
Veterans State Nursing Home Care	64.015	12,125,263
Veterans State Hospital Care	64.016	84,816
Veterans Housing-Guaranteed and Insured Loans	64.114	62,664,844****
All-Volunteer Force Educational Assistance	64.124	117,941
State Cemetery Grants	64.203	7,674,358
Other-U.S. Department of Veterans Affairs	64.999	1,173,940
Total U.S. Department of Veteran's Affairs		96,702,664
Environmental Protection Agency		
Air Pollution Control Program Support	66.001	9,633,599
State Indoor Radon Grants	66.032	177,073
Compliance Assistance Support for Services to the Regulated Community and Other Assistance Providers	66.305	16,962
Water Pollution Control State, Interstate, and Tribal Program Support	66.419	4,863,250
State Underground Water Source Protection	66.433	813,084
Water Quality Management Planning	66.454	746,051
National Estuary Program	66.456	287,978
Capitalization Grants for Clean Water State Revolving Funds	66.458	38,170,069
Nonpoint Source Implementation Grants	66.460	10,393,545
Regional Wetland Program Development Grants	66.461	182,725
Water Quality Cooperative Agreements	66.463	553,772
Capitalization Grants for Drinking Water State Revolving Funds	66.468	98,962,463
State Grants to Reimburse Operators of Small Water Systems for Training and Certification Costs	66.471	594,978
Beach Monitoring and Notification Program Implementation Grants	66.472	461,041
Water Protection Grants to the States	66.474	320,845
Environmental Protection-Consolidated Research	66.500	6,486,493
Office of Research and Development Consolidated Research/Training	66.511	224,780
Congressionally Mandated Projects	66.606	606,438
Consolidated Pesticide Enforcement Cooperative Agreements	66.700	1,576,188
Toxic Substances Compliance Monitoring Cooperative Agreements	66.701	54,950

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
TSCA Title IV State Lead Grants Certification of Lead-Based Paint Professionals	66.707	273,508
Pollution Prevention Grants Program	66.708	54,516
Pesticide Environmental Stewardship-Regional Grants	66.714	23,742
Surveys, Studies, Investigations, Training Demonstrations and Educational Outreach	66.716	3,031
Hazardous Waste Management State Program Support	66.801	7,592,303
Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements	66.802	1,097,107
State and Tribal Underground Storage Tanks Program	66.804	190,016
Leaking Underground Storage Tank Trust Fund Program	66.805	4,093,049
Solid Waste Management Assistance Grants	66.808	52,025
Superfund State and Indian Tribe Core Program Cooperative Agreements	66.809	170,449
State and Tribal Response Program Grants	66.817	1,608,819
Brownfield Assessment and Cleanup Cooperative Agreements	66.818	477
Environmental Education Grants	66.951	22,899
Total Excluding Clusters		190,308,225
Research and Development Cluster		
Pollution Prevention Grants Program	66.708	19,934
Total U.S. Environmental Protection Agency		190,328,159
Office of State and Tribal Programs, Nuclear Regulatory Commission		
Radiation Control-Training Assistance and Advisory Counseling	77.001	98,800
Department of Energy		
State Energy Program	81.041	3,402,607
Weatherization Assistance for Low-Income Persons	81.042	6,065,351
Environmental Restoration	81.092	282,996
Other - U.S. Department of Energy	81.999	745,628
Total Department of Energy		10,496,582

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Federal Emergency Management Agency		
Community Assistance Program-State Support Services Element (CAP-SSSE)	83.105	400,682
State Disaster Preparedness Grants	83.505	65,507
Flood Mitigation Assistance	83.536	620,759
Emergency Management Performance Grants	83.552	87,275
Pre-Disaster Mitigation	83.557	8,739
State and Local All Hazards Emergency Operations Planning	83.562	323,198
Total Federal Emergency Management Agency		1,506,160
Department of Education		
Adult Education-State Grant Program	84.002	67,928,774
Title I Grants to Local Educational Agencies	84.010	2,060,366,982
Migrant Education-State Grant Program	84.011	132,760,620
Title I Program for Neglected and Delinquent Children	84.013	1,530,691
Vocational Education-Basic Grants to States	84.048	106,922,671
Vocational Education-State Councils	84.053	343,786
Leveraging Educational Assistance Partnership	84.069	12,420,761
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	246,498,779
Rehabilitation Services-Service Projects	84.128	1,444,820
Independent Living-State Grants	84.169	3,837,156
Rehabilitation Services-Independent Living Services for Older Individual Who are Blind	84.177	3,368,685
Special Education-Grants for Infants and Families with Disabilities	84.181	54,185,481
Safe and Drug-Free Schools and Communities-National Programs	84.184	4,180,667
Byrd Honors Scholarships	84.185	4,182,125
Safe and Drug-Free Schools and Communities-State Grants	84.186	55,202,816
Supported Employment Services for Individuals with Severe Disabilities	84.187	1,774,262
Education for Homeless Children and Youth	84.196	8,720,640
Even Start-State Educational Agencies	84.213	26,299,850
Assistive Technology	84.224	545,765
Rehabilitation Services Demonstration and Training Programs	84.235	284,013
Tech-Prep Education	84.243	8,281,791

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Rehabilitation Training-State Vocational Rehabilitation Unit In-Service Training	84.265	497,236
Eisenhower Professional Development State Grants	84.281	8,832,750
Charter Schools	84.282	28,978,024
Twenty-First Century Community Learning Centers	84.287	185,470,536
State Grants for Innovative Programs	84.298	21,127,259
Education Technology State Grants	84.318	105,773,642
Special Education-State Personnel Development	84.323	2,094,212
Advanced Placement Program	84.330	1,120,042
Grants to States for Incarcerated Youth Offenders	84.331	1,740,697
Comprehensive School Reform Demonstration	84.332	32,161,433
Reading First State Grants	84.357	142,748,332
Rural Education	84.358	1,129,604
English Language Acquisition Grants	84.365	69,700,844
Mathematics and Science Partnerships	84.366	17,520,449
Improving Teacher Quality State Grants	84.367	71,924,357
Grants for State Assessments and Related Activities	84.369	35,790,338
Total Excluding Clusters		3,527,690,890
Student Financial Aid Cluster		
Federal Family Education Loans	84.032	26,929,831,756**
Special Education Cluster		
Special Education - Grants to States	84.027	1,154,061,602
Special Education - Preschool Grants	84.173	39,286,549
Total Special Education Cluster		1,193,348,151
Total U.S. Department of Education		31,650,870,797
National Archives and Records Administration		
National Historical Publications and Records Grants	89.003	88,540
Department of Health and Human Services		
Public Health and Social Services Emergency Fund	93.003	50,907,417
Project Grants for Facilities to Improve the Health Status of Minority Populations	93.005	49,976

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Special Programs for the Aging-Title VII, Chapter 3-Programs for Prevention of Elder Abuse, Neglect, and Exploitation	93.041	504,291
Special Programs for the Aging-Title VII, Chapter 2-Long Term Care Ombudsman Services for Older Individuals	93.042	1,343,203
Special Programs for the Aging-Title III, Part D-Disease Prevention and Health Promotion Services	93.043	2,016,843
Special Programs for the Aging - Title IV and Title II - Discretionary Projects	93.048	560,091
National Family Caregiver Support	93.052	16,793,181
Food and Drug Administration-Research	93.103	1,082,648
Maternal and Child Health Federal Consolidated Programs	93.110	412,536
Environmental Health	93.113	12,940
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	7,237,701*
Emergency Medical Services for Children	93.127	128,928
Primary Care Services Resource Coordination and Development	93.130	239,561
Injury Prevention and Control Research and State and Community Based Programs	93.136	9,377,947
Projects for Assistance in Transition from Homelessness (PATH)	93.150	6,983,618
Health Program for Toxic Substances and Disease Registry	93.161	825,394
Grants to State for Loan Repayment Program	93.165	713,536
Disabilities Prevention	93.184	288,919
Consolidated Knowledge Development and Application (KD&A) Program	93.230	2,258,070
Cooperative Agreements for State Treatment Outcomes and Performance Pilot Studies Enhancement	93.238	63,692
State Rural Hospital Flexibility Program	93.241	326,004
Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	3,251,165
Universal Newborn Hearing Screening	93.251	164,512
Rural Access to Emergency Devices Grant	93.259	169,914
Immunization Grants	93.268	216,735,595*
Substance Abuse and Mental Health Services - Access to Recovery	93.275	6,097,671
Centers for Disease Control and Prevention-Investigations and Technical Assistance	93.283	81,799,321*^
Small Rural Hospital Improvement Grant Program	93.301	263,580
Promoting Safe and Stable Families	93.556	60,667,416
Temporary Assistance for Needy Families	93.558	3,144,770,307
Job Opportunities and Basic Skills Training	93.561	16,893,547
Child Support Enforcement	93.563	550,942,368
Child Support Enforcement Research	93.564	13,203

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Refugee and Entrant Assistance-State Administered Programs	93.566	26,825,209
Low-Income Home Energy Assistance	93.568	104,953,261
Community Services Block Grant	93.569	55,674,290
Community Services Block Grant Formula and Discretionary Awards-Community Food and Nutrition Programs	93.571	461,671
Refugee and Entrant Assistance-Discretionary Grants	93.576	1,331,822
U.S. Repatriation	93.579	62,391
Refugee and Entrant Assistance-Targeted Assistance Grants	93.584	4,172,680
State Court Improvement Program	93.586	1,028,208
Community-Based Child Abuse Prevention Grants	93.590	3,067,185
Grants to States for Access and Visitation Programs	93.597	913,710
Chafee Education and Training Vouchers Program (ETV)	93.599	6,351,947
Head Start	93.600	199,324
Mentoring Children of Prisoners	93.616	204,686
Voting Access for Individuals with Disabilities-Grants to States	93.617	337,909
Developmental Disabilities Basic Support and Advocacy Grants	93.630	7,430,223
Children's Justice Grants to States	93.643	2,113,787
Child Welfare Services-State Grants	93.645	36,788,567
Social Services Research and Demonstration	93.647	34,952
Adoption Opportunities	93.652	316,197
Foster Care-Title IV-E	93.658	1,231,932,089
Adoption Assistance	93.659	289,356,153
Social Services Block Grant	93.667	389,244,542
Child Abuse and Neglect State Grants	93.669	2,281,612
Family Violence Prevention and Services/Grants for Battered Women's Shelters - Grants to States and Indian Tribes	93.671	8,249,012
Chafee Foster Care Independence Program	93.674	28,443,906
State Children's Insurance Program	93.767	1,075,124,318
Medicare-Supplementary Medical Insurance	93.774	5,616,342
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations	93.779	2,013,837
Grants to States for Operation of Offices of Rural Health	93.913	144,603
HIV Care Formula Grants	93.917	116,049,728
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938	615,616
HIV Prevention Activities - Health Department Based	93.940	14,141,016
HIV Demonstration, Research, Public and Professional Education Projects	93.941	94,257

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Human Immunodeficiency Virus (HIV)/Acquired Immuno-deficiency Virus Syndrome (AIDS) Surveillance	93.944	2,937,085
Trauma Care Systems Planning and Development	93.952	36,197
Block Grants for Community Mental Health Services	93.958	53,983,996
Block Grants for Prevention and Treatment of Substance Abuse	93.959	270,968,630
Preventive Health Services-Sexually Transmitted Diseases Control Grants	93.977	5,237,707
Preventive Health Services- Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	93.978	1,871,436
Mental Health Disaster Assistance and Emergency Mental Health	93.982	16
Health Program for Refugees	93.987	575,329
Cooperative Agreements for State-Based Diabetes Control Program and Evaluation of Surveillance Systems	93.988	932,702
Preventive Health and Health Services Block Grant	93.991	7,967,106
Maternal and Child Health Services Block Grant to the States	93.994	43,264,559
Other-Department of Health and Human Services	93.999	14,406,221
Total Excluding Clusters		8,001,651,129
Aging Cluster		
Special Programs for the Aging - Title III, Part B - Grants for Supportive Services & Senior Centers	93.044	34,741,471
Special Programs for the Aging - Title III, Part C - Nutrition Services	93.045	50,923,106
Nutrition Services Incentive Program	93.053	10,704,685
Total Aging Cluster		96,369,262
Child Care Development Fund Cluster		
Child Care and Development Block Grant	93.575	743,400,877
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596	156,254,389
Total Child Care Development Fund Cluster		899,655,266
Medicaid Cluster		
State Medicaid Fraud Control Units	93.775	18,715,101
State Survey and Certification of Health Care Providers and Suppliers	93.777	25,501,473
Medical Assistance Program	93.778	18,282,991,680
Total Medicaid Cluster		18,327,208,254

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Research and Development Cluster		
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	288,846
Consolidated Knowledge Development and Application (KD&A) Program	93.230	68,099
Substance Abuse and Mental Health Services-Projects of Regional and National Significance	93.243	124,551
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations and Evaluations	93.779	616,500
Total Research and Development Cluster		1,097,996
Total U.S. Department of Health and Human Services		27,325,981,907
Corporation for National and Community Service		
CalServ America	94.001	62,452
State Commissions	94.003	1,479,220
Learn and Serve America-School and Community Based Programs	94.004	2,265,578
AmeriCorps	94.006	27,123,106
Total Excluding Clusters		30,930,356
Foster Grandparent/Senior Companion Cluster:		
Foster Grandparent Program	94.011	1,470,035
Total U.S. Corporation for National and Community Service		32,400,391
Social Security Administration		
Disability Insurance/SSI Cluster		
Social Security-Disability Insurance	96.001	182,061,660
Department of Homeland Security		
State Domestic Preparedness Equipment Support Program	97.004	70,489,642
Urban Areas Security Initiative	97.008	44,429,022
Pre-Disaster Mitigation (PDM) Competitive Grants	97.017	2,270,000
Flood Mitigation Assistance	97.029	61,690
Crisis Counseling	97.032	108,963
Disaster Unemployment Assistance	97.034	3,430

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Individual and Family Grants	97.035	75
Disaster Grants-Public Assistance (Presidentially Declared Disasters)	97.036	176,910,593
Hazard Mitigation Grant	97.039	49,290,450
Emergency Management Performance Grants	97.042	5,106,499
Cooperating Technical Partners	97.045	66,994
Fire Management Assistance Grant	97.046	49,314,755
Pre-Disaster Mitigation Disaster Resistant Universities	97.063	46,221
Homeland Security Grant Program	97.067	12,567,692
Map Modernization Management Support	97.070	706,606
State Homeland Security Program	97.073	6,233
Total Department of Homeland Security		411,378,865
Office of National Drug Control Policy		
High Intensity Drug Trafficking Area	See Note 4	3,773,122
Miscellaneous Grants and Contracts		
Shared Revenue-Flood Control Lands	99.002	287,917
Shared Revenue-Grazing Land	99.004	194,591
Foreign Assistance to American Schools and Hospitals Abroad (ASHA) (2004)	99.006	287
U.S. Department of the Interior-Fire Prevention/Suppression Agreement	99.014	634,000
U.S. Department of Agriculture and Various Other U.S. Department-Fire Prevention/Suppression	99.016	13,087,882
Miscellaneous Federal Receipts	99.099	385,002
Miscellaneous Federal Receipts	99.999	2,000,055
Total Miscellaneous		16,589,734
Total Federal Awards Received		**$73,889,752,672**

* Amount includes value of commodities or food stamps.

** Amount includes loans and/or loan guarantees outstanding as of June 30, 2006.

*** Amount includes donated property.

**** Amount includes insurance in effect as of June 30, 2006.

^ Amount consis ts of several programs, including $75,558,247 for the Public Health and Preparedness and Response for Bioterrorism programs and $6,241,074 for the Breast and Cervical Cancer Control program.

NOTES TO THE SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2006

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, 2006. 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 $73,889,752,672 in total federal assistance consists of the following:

Cash assistance received	$44,175,255,797
Noncash federal awards	2,677,456,445
Loans and loan guarantees outstanding	26,974,375,586
Insurance in effect	62,664,844
Total	$73,889,752,672

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 noncash federal assistance received, loans and loan guarantees outstanding, and insurance in effect for the year ended June 30, 2006.

3. UNEMPLOYMENT INSURANCE

Of the $4,907,245,997 in total unemployment insurance funds (federal catalog number 17.225) received by the Employment Development Department during fiscal year 2005–06, $4,539,802,443 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, 2005 through June 30, 2006, 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	I5PLAP534	$ 1,086,350
	CV HIDTA/LA Police Chief's Association/ Stanislaus County	I4PVCP501	28,232
	CV HIDTA/LA Police Chief's Association/ Stanislaus County	I5PVCP501	118,589
	INCH/LA Police Chief's Association/ Riverside County	I5PLAP540Z	66,422
	INCH/LA Police Chief's Association/ Riverside County	I6PLAP540Z	24,393
	NV HIDTA/LA Police Chief's Association/ Las Vegas Metro PD	I3PNVP501Z	60,026
	NV HIDTA/LA Police Chief's Association/ Las Vegas Metro PD	I4PNVP501Z	52,578
	NV HIDTA/LA Police Chief's Association/ Las Vegas Metro PD	I5PNVP501Z	816
	NV HIDTA/LA Police Chief's Association/ Las Vegas Metro PD	I6PNVP501Z	10,278
	CA Border Alliance Group/ City of San Diego	I4PSCP575	85,045
	CA Border Alliance Group/ City of San Diego	I5PSCP575	1,415,993
	Northwest HIDTA/Washington State	I5PNWP505Z	46,500
	Clallaum Co Sheriff's Office	WASPC 04-WSMI-003	9,345
	Clallaum Co Sheriff's Office	2005CKWX0392	9,288
	Criminal Information Sharing Alliance	DCA1000310001	638,268
	Institute of Intergovernmental Research	2003RSCX1002	120,999
	Total		$3,773,122

The State was also loaned Federal Excess Personal Property (FEPP) from the U.S. Forest Service during the period July 1, 2005 to June 30, 2006. According to the California Department of Forestry and Fire Protection, the amount loaned from July 1, 2005 to June 30, 2006, was $5,686,390. 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:	**2005-12-1**
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:	**2005-13-1**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Subrecipient Monitoring. Health Services does not ensure the prompt resolution of all findings resulting from its monitoring reviews of local agencies' administration of their WIC programs.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-12-3**
Federal Program:	16.575
State Administering Department:	Governor's Office of Emergency Services
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Reporting. Certain reports Emergency Services submitted in fiscal year 2004–05 do not comply with applicable reporting requirements.
Status of Corrective Action:	Partially corrected. Financial Status Reports: The reconstruction is still in progress. The final report in the reconstruction effort is due to the Legislature in March 2007; however, the Victims of Crime Act (VOCA)

grant for federal fiscal year 2002 has been closed. The final 269 report was submitted March 10, 2006, and a close-out letter was received April 4, 2006.

Performance Reports: There are four responses by the Victim Services Branch to this finding with the following explanations:

Response 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.*

Emergency Services did request training and a site visit from our project manager, Delano Foster. Due to other work commitments, the visit has been postponed and is tentatively set for the week of September 11, 2006. In the interim, Mr. Foster has been very responsive to questions raised by the Federal Fund Project Manager regarding definitions, appropriate categories, etc. that are to be used when completing the Annual Report and also the Subgrant Award Reports. The majority of this correspondence has been by e-mails, and the responses have been shared with Victim Service Branch staff who work on VOCA-funded grants.[2]

Response 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.*

This has been completed. The matrix was used in compiling the statistics for the 2004–05 Annual Report.

Response 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*.

This has been completed. For the 2004–05 report, all Managers were provided (in writing) with the report requirements and timeframe and given a copy of the federal instructions and definitions for the 2004–05 Report. This information was then disseminated to staff at Section meetings. The Federal Project Manager also

reviewed the reporting requirements with the Section Chiefs at a Managers meeting prior to compiling the statistics for the report.

Response 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.*

This has been completed. All the spread sheets used to compile the statistics for the report are contained in a file outside of the Branch Chief's office, and another copy is kept by the Federal Funds Project Manager. In addition, all of this data is also kept electronically, both the statistical and narrative portions provided by each Section and also the completed report.

Reference Number:	**2005-13-2**
Federal Program:	16.575; 97.004 (formerly 16.007); 97.036; 97.039
State Administering Department:	Governor's Office of Emergency Services Governor's Office of Homeland Security
Fiscal Year Initially Reported:	2001–02
Audit Finding:	Subrecipient Monitoring. The Governor's Office of Emergency Services (OES) 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.
Status of Corrective Action:	A-133 Reports: Remains uncorrected/Agree with finding. OES has agreed 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, and has submitted an 2007-08 budget change proposal to request additional staff to perform subrecipient monitoring. When OES has adequate staff to perform all required work, OES will fully comply with all OMB Circular A-133 subrecipient monitoring requirements. Site Visits: Partially corrected. The following corrective actions have been completed:

- The Victim Services Branch developed a tracking process through an Excel spreadsheet as a management information tool. This spreadsheet tracks the dates site visits are scheduled, conducted, corrective action is taken, findings resolved, etc. Spreadsheets for each of the Branches within the Victim Services Branch are located on the shared drive.

- Staff instructions and corresponding forms for the Domestic Violence and Sexual Assault Sections, created as a consequence of Senate Bill 914, have been finalized. The instructions specify how to: prepare for a visit, conduct the visit, and identify issues found to be deficient; identify correction action required of the grant recipient; and, identify the timeline that corrective action must be taken. The instructions also provide information on how to follow-up on the satisfactory completion of corrective action. All of the dates for the above actions are also entered into the site visit spreadsheet.

  Domestic Violence and Sexual Assault Section staff have begun to use the new instructions and forms. It is anticipated that the other Sections within Victim Services will be using the new forms or a similar variation by the end of 2006.

The following corrective action has not been completed:

- The Victim Services Branch is not currently staffed to capacity and this has impacted the Branch's ability to conduct site visits, follow up on issues and document the results of the visits. OES had indicated, in their prior response to this finding, that this issue was being resolved as the Branch was in the process of hiring staff, although staff retention had become a new concern.

  Although hiring of new staff has taken place, the Branch has lost staff and therefore there are again vacancies. To compound the problem, it has now become more difficult to hire new staff as there is a limited pool of individuals to select from. OES is working on this problem and will be giving a new Criminal Justice Specialist exam by the end of 2006 which will create a new pool of candidates for the current vacancies.

  In addition, to ensure adequate staffing to conduct the necessary site visits and follow up on corrective actions as well as perform other required duties, OES will be requesting five additional positions and part of

their job duties will be to conduct and document sites visits and to follow up on findings. If these positions are approved, they are effective July 1, 2007, and new staff would be hired and ready to begin conducting visits by January 1, 2008.[3]

Reference Number:	**2005-2-2**
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. The Employment Development Department (EDD) allocated five of ten operating expense and equipment transactions we reviewed, even though it had not obtained federal approval to do so as part of its indirect cost rate proposal. 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.
Status of Corrective Action:	Partially corrected. On June 30, 2005, the EDD submitted the indirect cost rate proposal (ICRP) 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 ICRP 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 ICRP explains how costs will be distributed to programs in accordance with benefits received per federal regulations. The EDD met with the RCN after the original submission. The RCN agreed with the basis for most of the EDD's cost pool allocations, and identified only limited areas of concern. 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. A revised ICRP was submitted on May 1, 2006 to the RCN that included the results of a study to update the tax-sharing ratio based on the use of character count as the basis for applying the costs to benefiting federal and state tax programs. The RCN will be meeting with EDD staff in August 2006 to review the revised ICRP.[4]

Reference Number:	**2005-12-5**
Federal Program:	17.207; 17.801; 17.804; 17.225
State Administering Department:	Employment Development Department

Fiscal Year Initially Reported:	2004–05
Audit Finding:	Reporting. EDD did not have a process in place to review the accuracy of a reconciliation it used to complete its quarterly SF 272 reports.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-9-2**
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 (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).
Status of Corrective Action:	Partially corrected. The Caltrans Division of Local Assistance, Office of Project Implementation anticipated development and implementation of a new Master Agreement for all federally funded projects by June 2006 that would address the Bureau's finding. However, the issuance of the new Master Agreement has been delayed until September 2006 due to the need to implement new program requirements recently issued by the Federal Highway Administration.[5]

Reference Number:	**2005-2-3**
Federal Program:	39.011
State Administering Department:	Office of the Secretary of State
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Allowable Costs; Procurement and Suspension and Debarment. Although the Office of the Secretary of State 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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-2-1**
Federal Program:	84.010; 84.011
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Allowable Costs and Cost Principles. 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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-3-1**
Federal Program:	84.010
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001–02
Audit Finding:	Cash Management. 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.
Status of Corrective Action:	Partially corrected. 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, including seeking guidance from the United States Department of Education (ED). In May 2006, Education met with the ED Management Improvement Team, comprised of representatives from the ED Office of Under Secretary and ED Elementary and Secondary Education, to discuss risk management issues including cash management. The ED Risk Management Team understands that cash management for Education is multifaceted progressive process. 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.[6]

Reference Number:	**2005-3-2**
Federal Program:	84.365
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002–03
Audit Finding:	Cash Management. 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. 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.
Status of Corrective Action:	Fully corrected.[7]

Reference Number:	**2005-3-3**
Federal Program:	84.318
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002–03
Audit Finding:	Cash Management. 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 programs funds.
Status of Corrective Action:	Partially corrected. 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 a subrecipient spent 50 percent or more of the first payment the second 45 percent payment will be released. If a subrecipient spent less than 50 percent of the first payment, it will not receive a second payment until it certifies that the required percentage of funds has been spent. Final payments will be released after the end-of-period expenditure reports are 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 purchases 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 a subrecipient spent 80 percent of the first payment, the second payment will be released. If a 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 has 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 Education's web-based reporting system.[8]

Reference Number:	**2005-3-4**
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. [9]

Reference Number:	**2005-3-5**
Federal Program:	84.298

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2001–02

Audit Finding: Cash Management. 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.

Status of Corrective Action: Partially corrected. Education implemented revisions to the Consolidated Application to capture LEA expenditure data for the 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.[10]

Reference Number: **2005-5-1**

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: Fully corrected.

Reference Number: **2005-7-1**

Federal Program: 84.027

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2003–04

Audit Finding: Level of Effort—Maintenance of Effort. In response to our fiscal year 2003–04 recommendation, 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.

Status of Correction Action: Partially corrected. Education continues to seek guidance from the USDE as to what should be included or excluded from maintenance-of-effort calculations. In May 2006,

Education sent a letter to the USDE Office of Special Education Programs with mental health expenditures for 2002–03 along with an explanation of Education's concerns of incorporating the mental health expenditures in the maintenance-of-effort calculation. Although Education is working with the Department of Mental Health (DMH) on data issues, not all of Education's concerns have been fully resolved. For example, DMH data currently does not distinguish whether mental health expenditures were required by an individualized education program, versus being provided for medical reasons.[11]

Reference Number:	**2005-7-2**
Federal Program:	84.298
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Level of Effort—Supplement Not Supplant. 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.
Status of Corrective Action:	Partially corrected. Education continues to develop a process to determine whether the federal grant revenues supplement, rather than supplant, other funding for the Innovative Education program.[12]

Reference Number:	**2005-8-3**
Federal Program:	84.002; 84.287; 84.357
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Period of Availability. The Department of Education (Education) did not obtain the USDE's approval to liquidate obligations beyond the 90-day liquidation period for three of its grant awards. Although the liquidation period of 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
Status of Corrective Action:	Fully corrected.[13]

Reference Number:	**2005-14-1**
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 (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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-14-3**
Federal Program:	84.032
State Administering Department:	California Student Aid Commission
Fiscal Year Initially Reported:	2001–02
Audit Finding:	Special Tests and Provisions. 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.
Status of Corrective Action:	Partially corrected. Entity-wide Security Program Plan: In early federal fiscal year 2005–06, the auxiliary's Information Security Officer (ISO) developed an entity-wide security program plan. The auxiliary (EdFund) has since hired a new ISO who has developed a comprehensive enterprise information security policy/program which includes information security training awareness, as well as specific processes to improve the protection of FFEL Program data and sensitive applications.

Removal of Employee Electronic Access: The Internal Audit Department has reviewed 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. Internal Audit completed this review on August 28, 2006, and noted the following:

- In the first instance, the employee resigned from EdFund on Wednesday, August 4, 2004 without written notice. On this date, the Human Resources (HR) representative responsible for preparing the paperwork for exiting employees and sending the notification to EdFund's Technology Solutions & Services Division (TSS) was absent from work. Therefore, the notification was not sent and the employee-s access was not terminated until the HR representative returned to work on Friday, August 6, 2004.

  At the time of BSA's testwork, EdFund Procedure 07.31.01.641 *Notification of Exiting Employees for Removal of Information Systems Access* stated that an employee's access should be deleted no later than one business day from the employee's effective exiting date.

  Internal Audit noted that there was no back-up individual assigned to perform the notification function in the absence of the HR representative assigned to perform the task. Internal Audit noted that effective December 2005, HR assigned a back-up individual to perform the function in the absence of the assigned HR representative.

  Internal Audit recommended to HR to develop and implement a procedure that documents the step-by-step process in which management is required to follow when notifying HR of employee terminations. This procedure should include at a minimum a timeframe in which the steps within the procedure must occur and the HR personnel who must be contacted to report a termination, including the back-up staff. This will help ensure the prompt removal of employee access to EdFund's systems. HR management will develop such a procedure by September 15, 2006.

  In the second instance, Internal Audit noted that there is no procedure in place that provides guidance to EdFund management, or TSS, as to when an employee's access to EdFund's systems should be either suspended and/or deleted in the instance an employee fails to show up for work. EdFund's HR department will work collaboratively with TSS and the Information Security Officer (ISO) to develop and

implement a company wide procedure that defines the time line in which system access should be suspended and/or deleted for employees who have failed to show up for work without notice. Management will develop such a procedure by September 15, 2006.

- In the third instance, as stated above in the first instance reviewed by Internal Audit, HR assigned a back-up individual to perform the function in the absence of the assigned HR representative effective December 2005.

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 which would provide a systematic process for performing these updates including the creation of an automated audit trail. A project to implement these enhancements was developed and provided to executive management in March 2006. A start date, however, for the project has not been established. All updates/actions, however, continue to be performed using the data maintenance process implemented during fiscal year 2005–06.

The two divisions that currently perform data maintenance updates, Loan Operations and Default Management, 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. TSS is also responsible for reviewing and approving requests for new types of data maintenance updates to ensure that there is no systematic means to perform the requested change. Loan Operations and Default Management have also both developed and implemented formal procedures for requesting, authorizing and performing data maintenance changes.

Internal Audit is scheduled to perform a review of these newly implemented data maintenance processes during the 2006–07 fiscal year. The timing of this review provides Loan Operations and Default Management adequate time to accumulate sufficient documentation for Internal Audit to perform the review.

Operating Agreement: The California Student Aid Commission and EdFund intend to execute a new Operating Agreement no later than January 31, 2007, which will include such terms as are necessary to implement or respond to recommendations made by the Bureau of State Audits. In the interim, to allow sufficient time for development of the new Operating Agreement, the parties have agreed to enter into an extension of the current Operating Agreement. The new Operating Agreement will include such terms as are necessary to ensure that the auxiliary organization maintains strong controls over its information systems.[14]

Reference Number:	**2005-1-1**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Activities Allowed. The Department of Health Services does not always ensure that its fiscal intermediary pays Medicaid claims correctly.
Status of Corrective Action:	CALPOS Claim - Fully corrected. Inpatient Care Claim—Partially corrected. The Department of Health Services has issued Operating Instruction Letter #138-06 on April 28, 2006 to the fiscal intermediary, Electronic Data Systems, to do the mass update of the Provider Master File for the administrative day revenue codes for dates of service August 1, 2001 to August 1, 2005. In addition, a provider bulletin was published in June 2006 to notify inpatient providers regarding this update and the upcoming Erroneous Payment Correction (EPC). This EPC, which is estimated to be completed in September 2006, will adjust previously adjudicated claims that paid the incorrect rate and pay them the correct rate at the time the services are rendered.[15]

Reference Number:	**2005-2-4**
Federal Program:	93.283
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05

Audit Finding:	Allowable Costs. The Department of Health Services did not ensure that employees who worked full-time on the Bioterrorism program consistently completed the required certifications.
Status of Corrective Action:	Fully corrected. [16]

Reference Number:	**2005-3-6**
Federal Program:	93.283
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Cash Management. The Department of Health Services (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.
Status of Corrective Action:	Remains uncorrected/Disagree with finding. Health Services disagrees with the finding, and therefore the process for making quarterly advance payments to subrecipients remains unchanged. Health Services disagrees with the finding because: (1) Health Services is required by federal law to comply with state law, which expressly requires quarterly payments; (2) there is no guidance nor criteria upon which to base a finding that a quarterly payment is inconsistent with the federal timely disbursement requirement; and (3) the federal regulations provide for, contemplate, and acknowledge alternative methods of disbursing grant funds and circumstances under which a grantee would not be able to meet the requirement to minimize the time between receipt and disbursement of funds. Health Services concludes that both the State and federal requirements for grant financial funding apply. Both contain timely administration of payment criteria which are not inconsistent. State disbursement requirements are quarterly. Federal requirements must ensure a procedure to limit any time lags between receipt and disbursement of funds. It is unclear how a quarterly disbursement is inconsistent or noncompliant with a procedure that minimizes the time between receipt of grant funds and disbursements. Without specific criteria, there is nothing upon which to base a finding that these timeframes are inconsistent. Moreover, with the federal regulation requiring states administer grant funds in accordance with state requirements, doing anything other than quarterly disbursements (or whatever methodology required by state law) would violate this federal requirement. Assuming the state is disbursing funds in accordance with state law

(including but not limited to H&S 101317), and has a procedure in place that minimizes the lapse in time between receipt and disbursement of grant funds, then it is reasonable to conclude that the grant funds are being administered in accordance with federal requirements.[17]

Reference Number:	**2005-5-2**
Federal Program:	93.044
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Eligibility. The Department of Aging (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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-5-3**
Federal Program:	93.767
State Administering Department:	Managed Risk Medical Insurance Board
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Eligibility. Although the Managed Risk Medical 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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-8-1**
Federal Program:	93.569
State Administering Department:	Department of Community Services and Development
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Period of Availability. The Department of Community Services and Development did not ensure that it obligated federal funds within the applicable period of availability for the Community Services Block Grant.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-8-2**
Federal Program:	93.268
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Period of Availability. 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.
Status of Corrective Action:	Remains uncorrected/Agree with finding. Anticipated correction date is 12/31/06. Health Services communicated to staff the correct definition of encumbering funds. To ensure compliance with federal requirements, a monthly document is generated titled Status of Contracts. This document contains the name of each subrecipient, the funding award amount, contract term, and the status of the contract. Each subrecipient that does not have an executed contract is listed in bold to differentiate them from the remainder of the list. This document is monitored by contract staff and management staff to ensure that each contract is executed during the period of eligibility. In addition, each subrecipient has been notified of the consequences of not returning signed contracts by the deadline. The first notification occurred by conference call. Each subrecipient was told they must return signed contracts by the July 1st deadline. In June 2006, a written communication was also disseminated to subrecipients providing them with a deadline for submission of signed contracts and explaining that noncompliance could result in loss of funding.[18]

Reference Number:	**2005-8-4**
Federal Program:	93.283
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Period of Availability. The Department of 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 Health and Human Services to do so.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-9-1**
Federal Program:	93.563
State Administering Department:	Department of Child Support Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Suspension and Debarment. The Department of Child Support Services (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. The Bureau of State Audits used an alternative test to determine that the local child support agencies had not been suspended or debarred.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-12-4**
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 (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.
Status of Corrective Action:	Fully corrected.[19]

Reference Number:	**2005-13-3**
Federal Program:	93.575; 93.596
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Subrecipient Monitoring. Education did not adequately fulfill its subrecipient monitoring responsibilities for the child care cluster programs.
Status of Corrective Action:	Fully corrected.[20]

Reference Number:	**2005-13-4**
Federal Program:	93.917
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002–03
Audit Finding:	Subrecipient Monitoring. In its state application for funding to administer the HIV Care Formula Grants program, the Department of Health Services (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.
Status of Corrective Action:	Health Services did not conduct site visits for 11 of 37 subrecipients. Partially corrected. During the last BSA audit of February 2006, Care Services Program was sited for incomplete monitoring of 11 counties. In our response to the BSA, we agreed the monitoring for those counties was not completed as of the date specified in the report. To date, four counties have been fully monitored, three are scheduled to be complete within the next eight weeks, and two are undergoing an extensive audit by the DHS Audits and Investigations unit with a follow up monitoring scheduled soon after completion of the audit. (In addition to monitoring by program and fiscal staff, CSP funds a full time auditor within Audits and Investigations.) Two remaining counties, both with very small funding allocations and remotely located, have not been scheduled for an onsite monitoring visit due to limited staffing. Alternative oversight processes are being utilized to ensure program and contract compliance in those two counties, while site monitoring processes are scheduled for spring 2007. Health Services did not conduct site visits within the 18 month period ending June 30, 2005. Fully corrected. Health Services did not provide written reports documenting the results of the site visits. Fully Corrected. Health Services did not follow its procedures to ensure that it promptly received audit reports from non-profit subrecipients. Fully corrected.[21]

Reference Number:	**2005-13-6**
Federal Program:	93.268
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Subrecipient Monitoring. The Department of Health Services did not fulfill its subrecipient monitoring responsibilities for its Immunization Grants program.
Status of Corrective Action:	Fully corrected.[22]

Reference Number:	**2005-14-2**
Federal Program:	93.053
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Special Tests and Provisions. 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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-14-4**
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 (Health Services) did not always have the required agreements, disclosures, and certifications on file.
Status of Corrective Action:	Partially corrected. 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, Health Services is actively reenrolling individual physician providers identified as providers originally enrolled prior to 1998. This reenrollment effort includes 6 of the 14 providers identified in the compliance review that required agreements, disclosures, and certifications on file. The

most recent reenrollment phase, is anticipated to be completed in fiscal year 2006–07. Reenrollment of physician group providers originally enrolled prior to 1998 will ensue, ensuring that these providers have updated enrollment and disclosure agreement documents, and are in compliance with state and federal statute/regulations. Reenrollment of providers enrolled prior 1998 will continue until all of the identified providers have been reenrolled.

The Provider Enrollment Branch (PEB) continues to implement procedures to more efficiently review and process reenrollment applications based upon based upon data driven targeting of established fraud indicators (consistent with the Malcolm Sparrow anti-fraud model). PEB annually reviews their practices to identify and prioritize policies and procedures that can be updated and streamlined, facilitating the reenrollment process.

Consistent with Health Services' Medi-Cal Fraud Control Strategic Plan, high-risk provider types will continue to be identified jointly, by PEB and Audits and Investigations (A&I), utilizing an on-going risk assessment analysis and the annual Medi-Cal Payment Error Study (MPES). The identified provider types will be subjected to continued reenrollment efforts, as has been the case over the last year.

Health Services has implemented a plan for reenrollment of all high-risk provider types that were identified in the 2004 MPES during fiscal year 2005–06. As a result of this plan, PEB has commenced the reenrollment of optometrist, optometry groups, and physician group providers. Reenrollment efforts for years 2006–07 and 2007–08, will look to the results of the newly published 2005 MPES.

With respect to providers identified in the compliance review that required certifications on file, as well as agreements, disclosure statements, Health Services' Licensing and Certification Division (L&C) will be including review of these facilities during their December 2006, roll-out.

Health Services considers the finding to be partially corrected and will continue to reenroll providers until it is assured that all disclosure requirements are met.

The Licensing and Certification Program (L&C) has successfully amended its application forms to include the disclosure requirements under 42 CFR 455.104-106, and these forms have been fully integrated into the health facility provider application process.

L&C is currently reviewing the newly implemented Medi-Cal Provider Agreement (OHS 6208) to determine whether this document can be applied to non-long term care health facilities. Options being evaluated include the adoption of the OHS 6208, with an addendum that will provide direction on what sections will be required of health facilities, or the development of a health facility-specific provider agreement that is more closely aligned with the existing provider agreement for long-term care facilities. The Program intends to complete this task by December 2006, and will plan for a roll-out strategy wherein all non-long term care facilities certified by L&C will have in file a provider agreement.[23]

Reference Number:	**2005-9-3**
Federal Program:	97.004 (formerly 16.007)
State Administering Department:	Governor's Office of Emergency Services Governor's Office of Homeland Security
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Suspension and Debarment. The Governor's Office of 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.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-12-2**
Federal Program:	97.036
State Administering Department:	Governor's Office of Emergency Services
Fiscal Year Initially Reported:	2003–04
Audit Finding:	Reporting. The Governor's Office of Emergency Services reported incorrect financial information in its March 2005 quarterly progress report.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2005-12-6**
Federal Program:	97.036 & 97.039
State Administering Department:	Governor's Office of Emergency Services
Fiscal Year Initially Reported:	1999–00

Audit Finding:	Reporting. The Governor's Office of Emergency Services' (Emergency Services) financial status reports do not always contain complete expenditure information.
Status of Corrective Action:	Remains uncorrected/Agree with finding. Emergency Services has made several attempts over the years to discuss with the Federal Emergency Management Agency (FEMA) how best to report California disaster activity (which involves more than 20,000 plus individual projects) into a single generic format. Although Emergency Services has informally discussed the issue with FEMA staff, given the repeat nature of this finding, Emergency Services will initiate a formal request to FEMA management this year to reach a consensus on how to report on-going disaster activity without creating a burdensome workload for the state. Additionally, although many of the on-going disasters date back to 1990, Emergency Services will pursue a review of its internal fiscal and grant tracking systems to determine the availability of information. The systems currently in place may not have historical information available thus creating a monumental task to compile the old data with limited resources available.[24]

Reference Number:	**2005-14-5**
Federal Program:	97.067
State Administering Department:	Governor's Office of Homeland Security
Fiscal Year Initially Reported:	2004–05
Audit Finding:	Special Tests and Provisions. The Governor's Office of 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.
Status of Corrective Action:	Fully corrected.

ENDNOTES—AUDITOR COMMENTS

[1] The status of this issue has changed. Please refer to reference number 2006-12-10 for additional information.

[2] Emergency Services subsequently informed KPMG auditors that the visit Emergency Services had tentatively set for September 11, 2006 has been postponed indefinitely.

[3] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference numbers 2006-13-2 and 2006-13-3 for additional information.

[4] The U.S. Department of Labor approved the Employment Development Department's Indirect Cost Rate Proposal for the fiscal years ending June 30, 2001 through 2006 on September 21, 2006.

[5] Although Caltrans indicates that it has only partially implemented its corrective action plan, we did not find any reportable exceptions during our testing for fiscal year 2005-06.

[6] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-3-5 for additional information.

[7] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-3-8 for additional information.

[8] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-3-6 for additional information.

[9] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-3-9 for additional information.

[10] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-3-1 for additional information.

[11] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-7-5 for additional information.

[12] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-7-2 for additional information.

[13] Although Education indicates that it is obtaining the U.S. Department of Education's (USDOE) written approval before making payments that fall outside of the liquidation period moving forward, the USDOE indicated that it could not retroactively approve the transactions that Education paid during fiscal year 2004–05 beyond the 90-day liquidation period.

[14] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-14-7 for additional information.

[15] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-1-1 for additional information.

[16] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-2-1 for additional information.

[17] We reported a similar weakness in our audit of fiscal year 2005-06. Please refer to reference number 2006-3-11 for additional information. Also, according to the Bureau of State Audits Legal Counsel, the California Health and Safety Code, Subsection 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 federal regulations pertaining to cash management, it should seek clarification form the U.S. Department of Health and Human Services.

[18] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-8-2 for additional information.

[19] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-12-2 for additional information.

[20] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference numbers 2006-13-14 and 2006-13-15 for additional information.

[21] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-13-12 for additional information.

[22] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-13-13 for additional information.

[23] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-14-1 for additional information.

[24] We reported a similar weakness in our audit of fiscal year 2005–06. Please refer to reference number 2006-12-1 for additional information.

We conducted this audit to comply with Section 8546.3 of the California Government Code. The Independent Auditor's Report provides the opinions we expressed on the State of California's internal controls and on compliance and other matters.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: May 10, 2007

Staff: Denise L. Vose, CPA, Audit Principal
Joanne Quarles, CPA, Audit Principal
Brooke Blanchard
Benedicto Evangelista, Jr.
Ralph M. Flynn, JD
Daniel Hoang
Simi K. Khangura
Heather Kopeck, MPP
Julien Kreuze
Andrew Jun Lee
Jerry A. Lewis
Cathy Nystrom
Anh Pham, MS
Salvador Sanchez
Whitney M. Smith
Toufic Tabshouri, MBA
Charlene Tow
Leonard Van Ryn, CISA

Contractor: KPMG, LLP

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

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

April 26, 2007

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, 2006

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, 2006, and will be part of the Single Audit Report covering this period. We accept the reported findings and recommendations and recognize that several compliance findings resulted in qualified opinions for 19 major programs. We also recognize that our internal controls and administration of federal awards needs to be improved. As a result, the state has taken a proactive approach by implementing recent changes to the Financial Integrity and State Manager's Accountability Act (FISMA) reporting requirements. Beginning in the current year, each agency now must conduct an internal review of their controls and prepare a report of the findings. A certification letter alone will not meet the FISMA requirements. The state will continue to emphasize its commitment 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. 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 2005-06 Single Audit and remind all departments of the new internal auditing standards and processes included in Chapter 452, Statutes of 2006 (SB 1452).

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 systems 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 is committed to ensuring the proper financial operations and business practices of the state and ensuring 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 Fred Klass

MICHAEL C. GENEST
Director