CALIFORNIA

Single AUDIT REPORT

GRAY DAVIS, GOVERNOR

STATE OF CALIFORNIA

2001-02

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DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

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

May 29, 2003

Ms. Janet Rehnquist, Inspector General
Department of Health and Human Services
Room 5250, Cohen Building
330 Independence Avenue, S.W.
Washington, D.C. 20201

Dear Ms. Rehnquist:

As the Governor's fiscal representative, I submit to you the State of California Single Audit Report for the fiscal year ended June 30, 2002. 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. The Independent Auditor identified reportable conditions related to internal control over financial reporting, instances of noncompliance applicable to major federal programs, and reportable conditions involving the internal control over compliance with major federal program requirements. However, the cumulative reportable internal control weaknesses and instances of noncompliance were not considered material and do not adversely affect the State's general purpose financial statements or compliance with major federal program requirements.

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

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

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

Sincerely,

STEVE PEACE
Director

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Overview of California's Economy

FISCAL YEAR 2001–2002

As 2002 came to a close, both the national and California's economies were growing at a mild pace. Although better had been expected by midyear, labor markets were weak in California as in most of the rest of the nation. However, their recovery, now projected to be sluggish through most of 2003, is expected to gain momentum and ultimately pick up to a moderate pace in 2004.

CALIFORNIA FOLLOWS THE NATION

Like the nation, California is experiencing a jobless recovery. The state economy improved in the first half of 2002, with employment and total state personal income posting gains.

The improvement faltered at midyear, however. The state lost jobs between June and November, and personal income fell in the third and fourth quarters. In addition, unemployment continued to worsen throughout the year.

Still, home building was a bright spot in the California economy in 2002. The growing economy boosted residential construction in the late 1990s but not enough to satisfy rising demand, particularly in San Francisco Bay Area high technology centers. In fact, homebuilding throughout the economic recovery of the 1990s was very restrained compared to previous recoveries. Thus when the bubble burst in 2001, latent and unmet demand for new homes prevented a precipitous drop in residential permitting. Home building in 2001 matched the 2000 pace and then accelerated handily in 2002, rising nearly 11 percent over the previous year's rate.

In contrast, nonresidential building faced the latent impact of excessive commercial building spurred by the Internet boom in the late 1990s. Nonresidential construction, boosted by office and industrial projects, peaked in 2000 at over $18.6 billion — 12 percent more than the year before. The end of the boom in 2001 lead to a rapid slowdown in activity. Led by sharply curtailed office and industrial construc-

tion, nonresidential permitting dropped 9.6 percent in 2001 and over 14 percent in 2002. Office construction dropped almost 20 percent in 2001 and nearly 47 percent in 2002. Industrial construction slowed by nearly 30 percent in 2001 and almost 21 percent in 2002.

Because the high tech recession is being experienced on an international level, California has been hurt on a second front. Exports of made-in-California goods slowed dramatically in 2002 for the second year in a row. While exports of goods other than computers and electronics remained above 1999 levels, exports of computers and other electronic goods fell to their lowest level since 1997, the first year that data was published.

Like that of the nation, the California economy entered 2003 with little momentum. Labor markets were weak with no signs that significant improvement was imminent. The outlook for the California economy in 2003 depends heavily on the fate of the national economy. Near-historic low interest rates should help the state economy, as should continued strong spending on national defense and homeland security. On balance, the outlook for the California economy is one of slow growth in 2003 and moderate growth in 2004. Unemployment will likely increase somewhat in 2003 before falling in 2004.

The main risk to the outlook is the same as that for the national economy—a retrenchment by consumers. In addition, the state is facing increased risks from a delay in the high-tech recovery. As for the nation, the economy could be stronger than expected if a new federal fiscal stimulus package made up of well-designed, effective tax breaks and targeted increases in government spending are enacted.

Part One

State of California: Financial Report for the Year Ended June 30, 2002

State of California:

Financial Report
Year Ended June 30, 2002

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CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2002, 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 71 percent of the assets and 56 percent of the revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 99 percent of the assets and 99 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- Certain funds that represent 99 percent of the assets and 98 percent of the revenues of the Housing Loan fund, a major enterprise fund.
- 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 42 percent of the assets and 81 percent of the revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 90 percent of the assets of the fiduciary funds.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those funds and entities, is based solely 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, 2002, and the respective changes in financial position and the cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 of the basic financial statements, as of June 30, 2002, the State of California has implemented a new financial reporting model as required by the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*; GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*; GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*; and GASB Statement No. 38, *Certain Financial Statement Note Disclosures*.

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 on pages 7 through 24, and schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances and related notes on pages 134 through 140 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted

principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, based upon our audit and the reports of other auditors, is 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

January 24, 2003

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, 2002. We encourage readers to consider the information presented here in conjunction with information that is furnished in our letter of transmittal.

Because California implemented new reporting standards this fiscal year, which required significant changes in the content and structure of the financial statements, much of this information is not easily comparable to that of prior years. However, in future years comparisons will be more meaningful and will go further in explaining the State's financial position and results of operations.

Financial Highlights – Primary Government

Government-Wide Highlights

The effects of California's weak economy are reflected in the State's financial statements. The State experienced a significant decline in general revenues, primarily income and corporation tax revenues, but did not proportionately decrease its expenses. Revenues for its business-type activities approximated its expenses for all categories except unemployment programs, which had expenses that were $1.1 billion in excess of revenues. As a result, net assets for both governmental and business-type activities decreased during fiscal year 2001-02, but governmental net assets experienced a much greater decline, over 100%.

Net Assets — The assets of the primary government exceeded its liabilities on June 30, 2002, by $7.0 billion. After reducing this total amount by $11.9 billion for investment in capital assets (net of related debt), and by $14.5 billion for restricted net assets, the resulting unrestricted net assets were a negative $19.4 billion. Restricted net assets are dedicated for specified uses and not available to fund current activities. Much of the large negative unrestricted net assets is a result of the $16.7 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. The bonded debt reduces the unrestricted net assets, but the capital assets that would offset the reduction are recorded by local government.

Changes in Net Assets — The primary government's total net assets decreased by $13.3 billion (a 65.6% decrease) during the year ended June 30, 2002. Net assets of governmental activities decreased by $12.2 billion (a 116.4% decrease), while net assets of business-type activities showed a decrease of $1.1 billion (an 11.5% decrease).

Fund Highlights

Governmental Funds — As of June 30, 2002, the primary government's governmental funds reported a combined ending fund balance of $11.6 billion, a decrease of $12.2 billion from the previous fiscal year. After reducing this total fund balance amount by $17.6 billion in reserves, the unreserved fund balance totaled a negative $6.0 billion.

Proprietary Funds — As of June 30, 2002, the primary government's proprietary funds reported combined ending net assets of $9.4 billion, a decrease of $1.0 billion from the previous fiscal year. After reducing the total net assets by $9.1 billion for investment in capital assets (net of related debt) and expendable restrictions, the unrestricted net assets totaled $290 million.

Noncurrent Assets and Liabilities

As of June 30, 2002, the primary government's noncurrent assets totaled $45.4 billion, of which $22.1 billion was related to capital assets. However, state highway infrastructure projects completed prior to the year ended June 30, 2002, are not included in the capital assets of this report. As a result, the financial statements report liabilities, such as bonded debt, incurred to build infrastructure, but the related assets are not yet reported. They will be included during the retroactive reporting phase for infrastructure, which will occur not later than the year ending June 30, 2006.

The primary government's noncurrent liabilities totaled $50.6 billion, which consisted of $24.7 billion of general obligation bonds, $9.3 billion of revenue bonds, and $16.6 billion in other noncurrent liabilities.

Overview of the Financial Statements

This discussion and analysis is an introduction to the State's basic financial statements, which include three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains required supplementary information and other supplementary information.

Government-Wide Financial Statements

Government-wide financial statements are designed to provide readers with a broad overview of California's finances, in a manner similar to that of a private-sector business. The government-wide financial statements do not include programs and activities of the primary government and component units that are fiduciary in nature because their resources are not available to support State of California programs. The statements provide both short-term and long-term information about California's financial position, which assists the reader in assessing California's economic condition at the end of the fiscal year. These statements are prepared using the economic resources measurement focus and the accrual basis of accounting. This means they follow methods that are similar to those used by most businesses. They take into account all revenues and expenses connected with the fiscal year, regardless of when the cash involved was received or paid. 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 California's assets and liabilities, except for most state highway infrastructure assets, with the difference between the two reported as "net assets." Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of California is improving or deteriorating.

- The *Statement of Activities* presents information showing how California's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, revenues and expenses are reported in this statement 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 have separate columns for three different types of state programs or 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 twelfth-grade schools and 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* are normally intended to 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 lottery tickets, selling electric power, managing public employee retirement benefits, and administering long-term care and deferred compensation plans. These activities are carried out with minimal financial assistance from the governmental activities of the State.

- *Component units* are organizations that are legally separate from the State, but the State is either financially accountable for them, or the nature and significance of their relationship with the State is such that their exclusion would cause the State's financial statements to be misleading or incomplete. The State of California has both blended and discretely presented component units.

  - *Blended component units*, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from blended component units are integrated into the appropriate funds for reporting purposes. Certain building authorities that are blended component units of the State have been included in the governmental activities.

  - *Discretely presented component units* are legally separate from the primary government and provide services to entities and individuals outside the primary government. Activity of discretely presented component units, other than the activity of the University of California Retirement System, is presented in a single column in the government-wide 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 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 near-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 near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the State's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the State.

  Because the focus of governmental fund financial statements is narrower than that of government-wide financial statements, it is useful to compare these statements with 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 near-term financing decisions. Both the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures, and Changes in Fund Balances provide a reconciliation, to facilitate a comparison between governmental funds and governmental activities in the government-wide statements. These reconciliations are presented on the page immediately following these governmental fund financial statements. Primary differences between the government-wide and fund statements relate to noncurrent assets, such as land and buildings, and noncurent 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* are used to 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 activity for which a fee is charged to external users and are presented as business-type activities in the government-wide financial statements.

  - *Internal service funds* are used to 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* are used to account for resources held for the benefit of parties outside the State. Fiduciary funds 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 is much like that used for proprietary funds.

Discretely Presented Component Units Financial Statements

As discussed previously, discretely presented component units have operations for which the State

has financial accountability but they have certain independent qualities as well, and they operate similarly to private-sector businesses.

The activity of the component units other than that of the University of California Retirement System is classified as enterprise activity. The University of California Retirement System's financial information is provided in separate statements of fiduciary net assets and changes in fiduciary net assets.

Notes to the Financial Statements

The *notes to the financial statements* 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 discuss particular accounts in more detail, can be found 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. This section includes a schedule of funding progress for certain pension trust funds, a budgetary comparison schedule, and a separate reconciliation between the statutory fund balance for budgetary purposes and the fund balance for the major governmental funds presented in the governmental fund financial statements.

Other Supplementary Information

The next section contains *combining statements* that provide separate financial statements for nonmajor governmental funds, proprietary funds, fiduciary funds, and nonmajor component units; information for these entities is presented only in summary form in the basic financial statements. Finally, the *statistical section* provides various statistical data generally related to the State's financial condition.

Government-Wide Financial Analysis

Net Assets

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. The primary government's combined net assets (governmental and business-type activities) declined 65.6%, from $20.3 billion at June 30, 2001, to $7.0 billion a year later.

The largest segment of the primary government's net assets is its $11.9 billion investment in capital assets such as land, building, equipment, and infrastructure (roads, bridges, and other immovable assets), less any related debt used to acquire those assets that is still outstanding. The State uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the State's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, because the capital assets themselves cannot be used to liquidate the liabilities.

Another $14.5 billion of the primary government's net assets represents resources that are subject to external restrictions on how they may be used. Internally imposed designations of resources are not presented as restricted net assets. The balance of unrestricted net assets of governmental activities (if positive) may be used to meet the State's ongoing obligations to citizens and creditors. As of June 30, 2002, governmental activities showed an unrestricted net assets deficit of

$19.4 billion. The $16 million positive balance in unrestricted net assets of business-type activities is not available to meet the primary government's obligations for governmental activity.

A large portion of the negative unrestricted net assets of governmental activities is a result of the $16.7 billion in outstanding bonded debt being issued to build capital assets for school districts and other local governmental entities. The bonded debt reduces the unrestricted net assets, but the capital assets that would offset the reduction are recorded by local government, not the State.

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

Table 1

Net Assets – Primary Government
June 30, 2002
(amounts in millions)

	Governmental Activities	Business-Type Activities	Total
ASSETS			
Current and other assets	$ 40,987	$ 26,982	$ 67,969
Capital assets	17,412	4,638	22,050
Total assets	**58,399**	**31,620**	**90,019**
LIABILITIES			
Noncurrent liabilities	31,449	19,160	50,609
Other liabilities	28,666	3,745	32,411
Total liabilities	**60,115**	**22,905**	**83,020**
NET ASSETS			
Invested in capital assets, net of related debt	10,984	905	11,889
Restricted	6,717	7,794	14,511
Unrestricted	(19,417)	16	(19,401)
Total net assets	**$ (1,716)**	**$ 8,715**	**$ 6,999**

Changes in Net Assets

The expenses of the primary government totaled $149.8 billion for the year ended June 30, 2002. Of this amount, $67.2 billion (44.9%) was funded with program revenues (charges for services or program-specific grants and contributions), leaving $82.6 billion to be funded with general revenues (mainly taxes). However, only $69.3 billion of general revenues was received during the year, so the primary government's total net assets decreased by $13.3 billion, or 65.6%, during the year ended June 30, 2002.

Of the total decrease, net assets for governmental activities decreased by $12.2 billion, while those of business-type activities decreased by $1.1 billion. The decreases in governmental activities and the business-type activities were mainly caused by the economic downturn of 2001 and 2002, and primary government spending that significantly exceeded revenues.

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

Table 2

Changes in Net Assets – Primary Government
June 30, 2002
(amounts in millions)

	Governmental Activities	Business-Type Activities	Total
REVENUES			
Program revenues:			
Charges for services	$ 13,205	$ 18,386	$ 31,591
Operating grants and contributions	34,013	1	34,014
Capital grants and contributions	1,584	—	1,584
General revenues:			
Taxes	68,099	—	68,099
Investment and interest	791	—	791
Miscellaneous	375	—	375
Total revenues	**118,067**	**18,387**	**136,454**
EXPENDITURES			
Program expenses:			
General government	7,974	—	7,974
Education	45,883	—	45,883
Health and human services	53,057	—	53,057
Resources	3,594	—	3,594
State and consumer services	1,015	—	1,015
Business and transportation	7,532	—	7,532
Correctional programs	5,803	—	5,803
Tax relief	3,672	—	3,672
Interest on long-term debt	1,747	—	1,747
Housing loan	—	217	217
Electric power	—	4,241	4,241
Water resources	—	770	770
Public building construction	—	295	295
State lottery	—	2,913	2,913
Unemployment programs	—	8,901	8,901
Nonmajor enterprise	—	2,166	2,166
Total expenses	**130,277**	**19,503**	**149,780**
Deficiency before transfers	**(12,210)**	**(1,116)**	**(13,326)**
Transfers	13	(13)	—
Change in net assets	(12,197)	(1,129)	(13,326)
Net assets, July 1, 2001 (restated)	**10,481**	**9,844**	**20,325**
Net assets, June 30, 2002	**$ (1,716)**	**$ 8,715**	**$ 6,999**

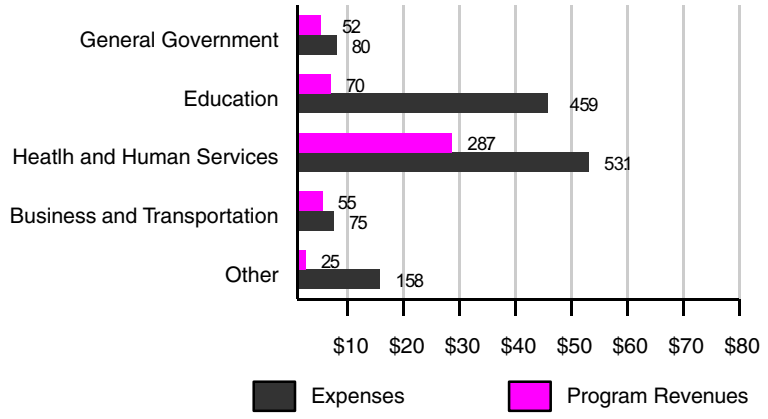
Governmental Activities

The expenses of governmental activities totaled $130.3 billion. Only $48.8 billion (37.5%) was funded with program revenues, $35.6 billion of which was federal grant money, leaving $81.5 billion to be funded with general revenues (mainly taxes). However, only $69.3 billion of general revenues was received for governmental activities during the year, so the governmental activities' total net assets decreased by $12.2 billion, or 116.4%, during the year ended June 30, 2002. The State issued short-term debt, revenue anticipation notes, and warrants to help meet its cash flow needs.

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, 2002
(amounts in billions)



For the year ended June 30, 2002, the weak economy caused a substantial reduction of the state tax revenues collected for governmental activities. Personal income taxes decreased mainly as a result of a severe drop in capital gains and stock option income, but expenses for governmental funds did not similarly decline. Much of the decline in tax revenues affected the General Fund, which also experienced an increase in expenses. The General Fund is discussed in more detail in Fund Financial Analysis, Governmental Funds.

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 – Governmental Activities
Year ended June 30, 2002
(as a percent)

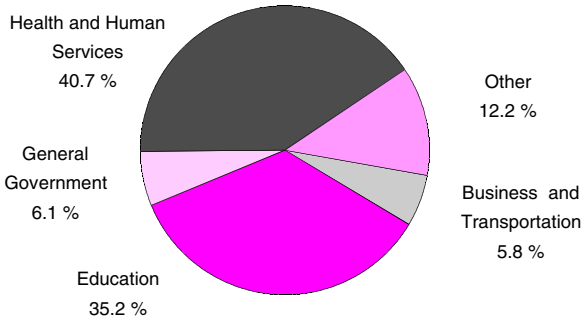
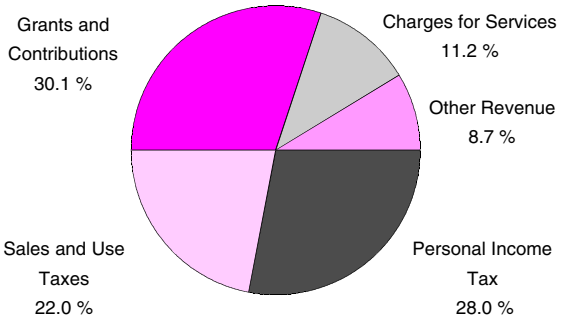


Chart 3

Revenues by Source – Governmental Activities
Year ended June 30, 2002
(as a percent)



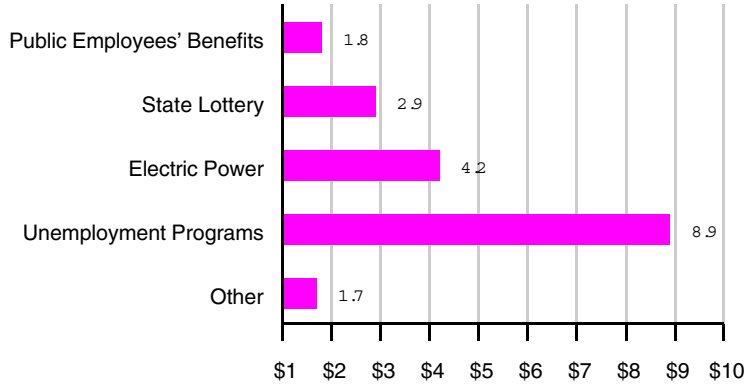
Business-Type Activities
The expenses of business-type activities totaled $19.5 billion, with $18.4 billion, or 94.3%, paid by program revenues, such as charges for services, and fees and penalties. Business-type activities' total net assets decreased by $1.1 billion, or 11.5%, during the year ended June 30, 2002.

Most of the decrease in net assets was the result of a $1.1 billion reduction in unemployment programs' net assets, discussed in more detail in Fund Financial Analysis, Proprietary Funds. As a result of the 2001 and 2002 economic downturn and increases in benefits, payments of unemployment and unemployment disability claims exceeded the insurance receipts for the fiscal year.

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

Chart 4

Expenses – Business-Type Activities
Year ended June 30, 2002
(amounts in billions)



Fund Financial Analysis

The State's economic weakness primarily affected governmental funds, which rely heavily on taxes to fund their programs. All but one of the major proprietary funds, the Unemployment Programs Fund, had revenues and expenses that were not substantially different from one another during the year ended June 30, 2002.

Governmental Funds
The Balance Sheet of the governmental funds reported $42.4 billion in assets, $30.8 billion in liabilities, and $11.6 billion in fund balances as of June 30, 2002. The largest asset accounts are cash and pooled investments, and due from other funds ($13.0 billion and $10.1 billion, respectively). The largest liability accounts are due to other funds, and contracts and notes payable ($7.0 billion and $7.5 billion, respectively). Within the total fund balance, $17.6 billion has been set aside in reserves. The reserved amounts are not available for new spending, because they have already been committed for outstanding contracts and purchase orders ($8.3 billion), noncurrent

interfund receivables and loans receivable ($3.6 billion), and continuing appropriations ($5.7 billion). The balance of the governmental funds that is unreserved is a negative $6.0 billion.

The Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds shows $117.7 billion in revenues, $133.1 billion in expenditures, and a net $3.2 billion from other financing sources (uses). The largest sources of revenue are $68.0 billion from taxes and $36.8 billion from other governments (mainly the federal government). The programs having the largest expenditures are health and human services, with expenditures totaling $53.1 billion, and education, with $45.3 billion. The ending fund balance of the governmental funds for the year ended June 30, 2002, was $11.6 billion, which was $12.2 billion less than the previous year's ending fund balance of $23.8 billion. The primary reason for the decrease in the combined fund balance of the governmental funds was the economic recession, which caused a substantial deterioration in state tax revenue, without a comparable decrease in expenditures. Personal income taxes, which account for 48.4% of tax revenues and 27.9% of total governmental fund revenues, fell by $11.8 billion from the previous fiscal year, mainly as a result of a severe drop in capital gains and stock option income.

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 negative fund balance of $3.5 billion. The Federal Fund and the Transportation Construction Fund ended the fiscal year with fund balances of $44 million and $2.5 billion, respectively. The nonmajor governmental funds ended the year with a total fund balance of $12.5 billion.

As shown on the Balance Sheet, the General Fund (the State's main operating fund) ended the fiscal year with assets of $13.8 billion, liabilities of $17.3 billion, and fund balance reserves of $2.5 billion. This left the General Fund with an unreserved fund deficit of $6.0 billion. The largest assets of the General Fund are due from other funds of $6.9 billion and receivables (net) of $5.6 billion. The largest liabilities are contracts and notes payable of $7.5 billion and due to other governments of $3.0 billion.

As shown on the Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds, the General Fund had $63.9 billion in revenues, $73.9 billion in expenditures, and a net $1.1 billion in disbursements from other financing sources (uses) for the year ended June 30, 2002. The largest source of revenue to the General Fund was $61.8 billion from taxes, primarily personal income taxes ($32.9 billion) and sales and use taxes ($21.3 billion). Sales and use tax revenues to the General Fund were approximately equal to those from the prior fiscal year, but personal income tax revenues were not, dropping $11.8 billion. Although corporation taxes make up a much smaller amount of revenues to the General Fund, their $2.0 billion decrease to $4.6 billion also contributed significantly to the reduction in the fund balance. Additionally, General Fund expenditures increased by $1.5 billion, to $73.9 billion. The programs with the largest expenditures were education, which decreased $797 million to $37.0 billion, and health and human services, which increased $1.6 billion to $21.5 billion. The ending fund balance (including reserves) of the General Fund for the year ended June 30, 2002, was a deficit of $3.5 billion, which was $11.1 billion less that the previous year's ending fund balance of $7.6 billion.

The Federal Fund, also a major fund, reports federal grant revenues and the related expenditures to support the grant programs. By far the largest of these program areas was health and human services, which accounts for $24.6 billion of the total $33.7 billion in expenditures for the Federal Fund. 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, $4.9 billion, most of which is provided to local educational agencies. Overall revenues and expenditures increased by approximately $2.8 billion and $3.0 billion, respectively, over prior year fund activity.

The third major governmental fund, the Transportation Construction Fund, accounts for gasoline taxes, bond proceeds, and other revenues used for highway and passenger rail construction. Revenues and expenditures remained relatively stable during fiscal year 2001-02, compared to prior year activity. However, expenditures ($3.6 billion) exceeded revenues ($3.2 billion) by approximately $400 million, contributing to a reduction in fund balance.

Proprietary Funds

In general, the weak economy did not have the negative effect on enterprise funds that it did on governmental funds. Most major enterprise funds' activity remained stable, with revenues approximating expenses. The exception was the Unemployment Programs Fund, which had expenses that exceeded revenues by $1.1 billion, accounting for almost the entire decrease in net assets for all enterprise funds.

As shown on the Balance Sheet of the proprietary funds, total assets of the enterprise funds were $38.4 billion as of June 30, 2002. Of this amount, current assets totaled $14.3 billion and noncurrent assets totaled $24.1 billion. The largest asset accounts were recoverable power costs (net) of $7.3 billion in the Electric Power Fund and amount on deposit with the U.S. Treasury of $6.0 billion in the Unemployment Programs Fund. The total liabilities of the enterprise funds were $29.7 billion. Of this amount, current liabilities totaled $4.0 billion and noncurrent liabilities totaled $25.7 billion. The largest liability accounts were revenue bonds payable of $8.5 billion, and an interfund payable of $6.5 billion, which is mainly due to the General Fund from the Electric Power Fund.

Total net assets of the enterprise funds were $8.7 billion as of June 30, 2002. Total net assets consisted of three segments: expendable restricted net assets of $7.8 billion; investment in capital assets (net of related debt) of $906 million; and unrestricted net assets of $16 million. The fund with the largest net assets was the Unemployment Programs Fund, with $5.6 billion (63.9% of the enterprise funds' total net assets).

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 $17.8 billion, operating expenses of $17.6 billion, and net disbursements from other transactions of $1.3 billion. As a result, total net assets were reduced by $1.1 billion, from $9.8 billion at the end of the previous year, to $8.7 billion at the end of the 2001-02 fiscal year. The largest sources of operating revenue were unemployment and disability insurance receipts of $6.9 billion, and power sales of $4.1 billion collected by the Electric Power Fund. The largest operating expenses were the distribution to beneficiaries of $8.7 billion by the Unemployment Programs Fund and power purchases (net of recoverable costs) of $3.6 billion by the Electric Power Fund. The ending net assets of the enterprise funds for the year ended June 30, 2002, were $8.7 billion, or $1.1 billion less than the previous year's ending fund balance of $9.8 billion. The decrease was caused by an excess of unemployment and unemployment disability claim payments over unemployment insurance receipts, as a result of the 2001-02 economic downturn and increased benefit payments.

In the Unemployment Programs Fund, operating expenses increased to $8.9 billion from $5.3 billion in the prior year. Several factors contributed to the change: an increase in the number of unemployed workers as a result of the economic downturn; an increase in the maximum weekly benefit amount allowed under the unemployment program, effective January 1, 2002; federal-government-funded extensions to unemployment benefits; and a retroactive increase to benefits for people who received unemployment payments between September 11, 2001, and December 31, 2001. Operating revenues also increased, to $7.4 billion from $5.8 billion in the prior year, primarily because of a $937 million grant from the federal government. The purpose of the grant was to pay for increased unemployment expenses caused by the economic hardship in the wake of the September 11, 2001, attack on the United States. A large portion of these expenses did not result in actual cash disbursements during the 2001-02 fiscal year. Instead, the State accrued $1.2 billion in benefits payable as of June 30, 2002, almost $1.0 billion more than it accrued in benefits payable for the prior fiscal year.

Total net assets of the internal service funds were $698 million as of June 30, 2002. These assets consist of three segments: investment in capital assets (net of related debt) of $500 million; unrestricted net assets of $274 million; and expendable restricted net assets of a negative $76 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 $626 million. The pension and other employee benefit trust funds ended the fiscal year with net assets of $244.6 billion. The State's only investment trust fund, the Local Agency Investment Fund, ended the fiscal year with net assets of $19.6 billion. Agency funds act as clearing accounts and thus do not have net assets.

For the year ended June 30, 2002 the fiduciary funds‘ combined net assets were $264.8 billion, a $17.9 billion decrease from the prior year. The main reason for the decrease in net assets was a substantial drop in the fair value of investments of retirement funds.

Performance of the Economy for the Year Ending June 30, 2002

Economic growth cooled in the state during 2002. Job losses were significant in Northern California, and the real estate markets weakened during the first half of the year. Greater strength was observed in the Southern California economy, where unemployment rates remained low, consumers kept spending, and home buying surged to all-time record highs. In May 2002, the median selling price of a home in Southern California eclipsed $300,000 for the first time ever.

The centers of technology production, Silicon Valley and many Bay Area enclaves, followed the industrial heartland of America into recession. The Bay Area remained considerably weak throughout 2002, especially in the commercial market, due largely to the lack of job growth. Office vacancy rates moved dramatically higher in Santa Clara County and downtown San Francisco. The San Jose office vacancy rate soared to 19%; the San Francisco rate was over 24%.

The leading area of job growth in the state was the Inland Empire, namely Riverside and San Bernardino counties, followed by San Diego. However, job growth slowed from the frenetic pace

of 2001. Much of the job gain in the Inland Empire occurred in services, construction, education, and wholesale distribution.

Personal income growth during the first half of 2002 for the State was weak. The growth of wage and salary income was limited because employment growth remained flat. As a result of the weak stock market, capital gains income was virtually nonexistent.

Affordable housing became a principal challenge facing the State. What has been missing from the housing boom of the late 1990s is production of homes. Limited production leads to higher prices and rents, and increased congestion. During fiscal year 2002, the State experienced very high home prices, increased apartment rents, and more congestion on the highways.

General Fund Budgetary Highlights

The General Fund's final budget for the year ended June 30, 2002 was $309 million lower than the appropriations in the original budget. Most of this reduction was related to educational programs. The downward revision was driven primarily by a dramatic decline in personal income tax revenues related to capital gains and stock option income. These revenue sources were the same factors that caused the revenue growth in recent years and the abrupt revenue decline beginning in the 2001-02 fiscal year. The Legislative Analyst, fiscal experts, and state political leaders have not seen a near-term rebound in these revenue sources; thus, there is an ongoing need to restrain statewide expenditures beyond the 2001-02 fiscal year. Table 3 summarizes the differences between the original and the final budget amounts for the General Fund.

The General Fund revenue shortfall in the 2001-02 fiscal year was partially addressed by mid-year statewide spending reductions. As a consequence of the spending reductions, the General Fund ended the fiscal year with $3.2 billion less expenditures than was budgeted. Most of the expenditure reductions were directed at education spending. However, the 2001-02 school spending still exceeded the amount required by law (Proposition 98), even after the reductions.

The $309 million in General Fund appropriation reductions and the $3.2 billion of unexpended General Fund appropriations totaled $3.5 billion of General Fund savings. These savings lowered the amount of the fund balance deficit of the General Fund to $2.1 billion on a budgetary basis. Information on the General Fund budget, actual expenditures, and variance with the final budget are presented in the Required Supplementary Information that follows the notes to the statements.

Table 3

General Fund Original and Final Budgets
Year ended June 30, 2002
(amounts in millions)

	Original	Final	Increase / (Decrease)
Budgeted Amounts			
State and consumer services	$ 591	$ 644	$ 53
Business and transportation	186	177	(9)
Resources	1,568	1,566	(2)
Health and human services	22,480	22,609	129
Correctional programs	5,097	5,261	164
Education	39,875	39,104	(771)
General government:			
Tax relief	3,438	3,438	—
Debt service	2,485	2,485	—
Other general government	4,303	4,430	127
Total	**$ 80,023**	**$ 79,714**	**$ (309)**

Capital Assets and Debt Administration

Capital Assets

The State of California's investment in capital assets for its governmental and business-type activities as of June 30, 2002, amounted to $22.1 billion (net of accumulated depreciation). This investment in capital assets includes: land, buildings and other depreciable property; a small portion of the state highway infrastructure; 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. The category of state highway infrastructure consists of current year additions and improvements to the State Highway System. Infrastructure assets are items that are normally immovable and of value only to the State, such as roads, bridges, streets and sidewalks, drainage systems, lighting systems, and similar items.

Table 4 presents a summary of the State of California's capital assets for governmental and business-type activities as of June 30, 2002.

Table 4

State of California's Capital Assets
Year ended June 30, 2002
(amounts in millions)

	Governmental Activities	Business-Type Activities	Total
Capital assets			
Land	$ 2,954	$ 6	$ 2,960
State highway infrastructure	59	—	59
Buildings and other depreciable property	17,126	6,848	23,974
Less: accumulated depreciation	(5,258)	(2,649)	(7,907)
Construction in progress	2,531	433	2,964
Total	**$ 17,412**	**$ 4,638**	**$ 22,050**

Over $1.8 billion in capital projects was authorized in the 2001-02 fiscal year, not including funding for transportation infrastructure. The General Fund contributes approximately $200 million of the total and the balance comes from various bond and special funds. The major capital projects authorized include:

- $349 million to construct a 1,500-bed facility in Coalinga for the Department of Mental Health;
- $160 million for construction at the Merced campus of the University of California;
- $95 million for construction on the California Institutes for Science and Innovation; and
- $609 million to fund 38 new projects and continuing phases of 106 additional projects for the University of California, California State University, and California Community Colleges.

Modified Approach for Infrastructure Assets
All current-year additions to the state highway infrastructure are being reported using the modified approach. As allowed by the retroactive reporting provisions established by the Governmental Accounting Standards Board, infrastructure projects completed prior to the year ending June 30, 2002, are not included in this report. Retroactive reporting of the state highway infrastructure in the financial statements will occur not later than the year ending June 30, 2006.

Debt Administration
In January 2002, the State Treasurer announced the State's new *Strategic Debt Management Plan*. Under this plan, the State changes how it makes payments on new general obligation bond issuances by shifting from its practice of making level principal payments to making level debt service payments (principal and interest combined). In addition, the plan calls for the deferral of initial principal payments on newly issued general obligation bonds. Although intended to aid in closing the State's near-term budget shortfall, both of these practices individually will result in the primary government incurring increased interest costs in the future because of the delay in paying off outstanding principal balances.

The plan also targets the restructuring of certain general obligation bonds to achieve one-time reductions in debt service requirements and to facilitate a faster transition to level debt service payments. Although debt restructuring during the year ended June 30, 2002, reduced current debt service payments by $223 million, it achieved this reduction by increasing future debt service

requirements by $1.0 billion. This advance refunding resulted in an economic gain of $21 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 5.5% per year over the life of the new bonds.

Lastly, the plan includes the issuance of variable rate debt for a portion of the State's general obligation bond portfolio beginning in fiscal year 2002-03. This practice can be beneficial because, historically, variable rate bonds are issued at rates below those of fixed rate bonds. Also, when market rates fall, interest rates decrease. However, when market rates rise, so do interest payments on outstanding principal balances.

At June 30, 2002, the primary government had total bonded debt outstanding of $35.0 billion. Of this amount, $25.3 billion (72.3%) represents general obligation bonds, which are backed by the full faith and credit of the State, and $9.7 billion (27.7%) represents revenue bonds, which are secured solely by specified revenue sources. Table 5 presents a summary of the primary government's long-term obligations as of June 30, 2002.

Table 5

State of California's Long-Term Obligations
Year ended June 30, 2002
(amounts in millions)

	Governmental Activities	Business-Type Activities	Total
Government-wide noncurrent liabilities			
General obligation bonds	$ 21,606	$ 3,108	$ 24,714
Revenue bonds	752	8,547	9,299
Certificates of participation and commercial paper	530	3,937	4,467
Capital lease obligations	3,431	—	3,431
Other noncurrent liabilities	5,130	3,568	8,698
Total noncurrent liabilities	**31,449**	**19,160**	**50,609**
Payable from the Electric Power Fund to the General Fund	—	6,496	6,496
Current portion of long-term obligations	1,167	1,093	2,260
Total long-term obligations	**$ 32,616**	**$ 26,749**	**$ 59,365**

The primary government's total long-term obligations increased by over $2.0 billion during the year ended June 30, 2002. The main reason for the increase was the issuance of $3.0 billion in general obligation bonds and the redemption of $1.5 billion in general obligation bonds, for a net increase of $1.5 billion. The new bonds were issued mainly to finance the building and repair of education facilities.

Two statewide bond measures were passed by the voters in March 2002. Proposition 40, the California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act of 2002, and Proposition 41, the Voting Modernization Bond Act of 2002, increased the unused authorization to issue bonds by $2.8 billion.

Additional information on the State's long-term obligations can be found in Note 8, Long-Term Obligations, and Notes 9 through 14.

Recent Economic Events and Future Budgets

Recent Economic Events

The national economic recovery is under way, but is moving slowly. The fundamental indicators suggest that the economy is in the early stages of recovery, and employment growth will be sluggish. To a considerable degree, rising home prices have maintained consumer morale that could have decreased as a result of the decline in household net worth caused by the stock market crash. Furthermore, falling mortgage rates have triggered a spate of home refinancings, resulting in lower payments and extra monthly disposable income. This has allowed consumers to remain the engine of growth.

Unlike the nation's economy, the California economy has moved sideways during the second half of 2002. Employment continued to decline slightly. The job gains that have been recorded in California during the latter part of 2002 are almost entirely limited to the public sector. The Bay Area remains particularly afflicted by the weakness in employment growth, and recent labor market data showed a worsening trend. But, some stability in the Bay Area economy was observed as the 2002 calendar year ended. The Southern California labor market has strengthened since the autumn months of 2002, with unemployment rates falling for much of calendar year 2002.

The information technology and telecommunications sectors continue to suffer from substantial excess capacity and poor earnings. However, semiconductor sales have rebounded since the summer and autumn months of 2002. The Asian markets are responsible for much of the new demand in semiconductors this year.

Despite unprecedented demand for housing this year, residential construction is not booming in California. The home-building pace in 2002 is higher than a year ago, but still modest in view of the unprecedented demand for homes.

State of California's Future Budgets

California's 2002-03 budget was enacted on September 5, 2002. It projected total General Fund revenues to be $79.2 billion and General Fund expenditures to be $76.7 billion in the 2002-03 fiscal year. The budget included many one-time budget enhancements, such as the sale of $4.5 billion in tobacco revenue bonds that are secured by the State's future receipts of settlement monies from tobacco companies, $2.0 billion in loans from special funds, $860 million of temporary reductions in debt service payments, and a $1.1 billion increase in federal funding. These one-time budget enhancements enabled the State to budget General Fund expenditures that are only $171 million above the expenditure level of the 2001-02 fiscal year.

In light of the uncertainty of the economic climate and its direct impact on state tax revenues, in October and November 2002, the State issued a total of $12.5 billion in Revenue Anticipation Notes (RANs), the largest external loan of its type in California history, to ensure that sufficient cash resources are available for the 2002-03 fiscal year. The State also completed the long-pending sale of energy revenue bonds in the amount of $11.3 billion. The bond proceeds were used primarily to repay the $3.5 billion interim energy loan from the banks and commercial lenders and the $6.5 billion loan from the General Fund. Charges for power to commercial and residential

customers in California will repay these revenue bonds. As of January 24, 2003, the primary government had $25.7 billion in outstanding general obligation bonds.

State revenue collections continued to fall below projections. In December 2002, the Governor proposed to the Legislature a plan for mid-year spending reductions and adjustments that would reduce expenditures by $3.4 billion for the 2002-03 fiscal year and an additional $6.8 billion for the 2003-04 fiscal year. The 2002-03 reductions and adjustments are largely directed at education, health, and transportation spending. The proposed savings for the 2003-04 fiscal year include suspending the expenditure of about $1.0 billion in gasoline sales tax revenues on infrastructure projects.

On January 10, 2003, the Governor's 2003-04 budget proposal was released, which estimated a $34.6 billion budget shortfall through June 30, 2004. In addition to the $10.2 billion in expenditure reductions and adjustments proposed in December 2002, the Governor proposed to balance the budget with $11.8 billion in cuts and savings, $8.0 billion in state-local realignment funded by revenue increases, $1.1 billion in fund shifts, $1.9 billion in transfers and other revenue, and approximately $1.6 billion in loans and borrowing. The $10.2 billion in savings proposed by the Governor in December and the additional $24.4 billion in savings proposed in the Governor's 2003–04 Budget are intended to resolve the total $34.6 billion budget shortfall by the end of the 2003-04 fiscal year. It is not known which elements of the Governor's budget proposals will ultimately be enacted.

The Legislative Analyst's Office believes that, even though the shortfall and the required solutions are somewhat overstated in the *Governor's Budget,* the budget problem is still enormous. Balancing the State of California's budget (as required by law) will be difficult to achieve without severely reducing programs, increasing taxes or other revenues, or both.

Requests for Information

This financial report is designed to provide a general overview of the State of California's finances to interested parties. Questions concerning the information provided in this report or requests for additional information should be addressed to the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

Basic Financial Statements

Government-Wide Financial Statements

Statement of Net Assets

June 30, 2002
(amounts in thousands)

	Primary Government			
	Governmental Activities	Business-Type Activities	Total	Component Units
ASSETS				
Current assets:				
Cash and pooled investments	$ 13,521,781	$ 4,835,062	$ 18,356,843	$ 1,414,790
Amount on deposit with U.S. Treasury	—	5,951,533	5,951,533	—
Restricted assets:				
Cash and pooled investments	—	120,756	120,756	—
Investments	—	34,536	34,536	12,422
Investments	403,289	1,193,072	1,596,361	8,276,397
Receivables (net)	8,153,841	409,916	8,563,757	2,152,923
Internal balances	6,513,042	(6,513,042)	—	—
Due from primary government	—	—	—	257,801
Due from other governments	7,888,536	177,206	8,065,742	131,492
Prepaid items	36,363	7,940	44,303	5,545
Food stamps	399,415	—	399,415	—
Inventories	95,043	13,992	109,035	104,906
Recoverable power costs (net)	—	1,318,000	1,318,000	—
Other current assets	82,714	15,250	97,964	207,075
Total current assets	37,094,024	7,564,221	44,658,245	12,563,351
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	374,937	374,937	—
Investments	—	95,922	95,922	4,893
Investments	—	2,791,062	2,791,062	16,597,569
Net investment in direct financing leases	—	4,813,942	4,813,942	—
Receivables (net)	779,631	36,431	816,062	289,936
Loans receivable	3,104,775	2,565,027	5,669,802	6,652,885
Recoverable power costs (net)	—	7,263,000	7,263,000	—
Deferred charges	8,057	1,459,682	1,467,739	83,337
Capital assets:				
Land	2,953,351	6,300	2,959,651	402,132
State highway infrastructure	59,262	—	59,262	—
Buildings and other depreciable property	17,126,240	6,847,895	23,974,135	18,258,534
Less: accumulated depreciation	(5,257,969)	(2,649,234)	(7,907,203)	(8,983,034)
Construction in progress	2,530,985	433,319	2,964,304	2,229,657
Other noncurrent assets	—	17,588	17,588	303,719
Total noncurrent assets	21,304,332	24,055,871	45,360,203	35,839,628
Total assets	**$ 58,398,356**	**$ 31,620,092**	**$ 90,018,448**	**$ 48,402,979**

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	$ 9,393,226	$ 769,761	$ 10,162,987	$ 1,190,637
Due to component units	257,801	—	257,801	—
Due to other governments	5,717,822	231,705	5,949,527	9,467
Dividends payable	—	—	—	247,023
Deferred revenue	403,534	18,679	422,213	766,598
Tax overpayments	2,624,058	—	2,624,058	—
Deposits	70,056	4,192	74,248	884,691
Contracts and notes payable	7,532,802	4,113	7,536,915	6,131
Advance collections	508,036	40,240	548,276	261,032
Interest payable	342,030	128,447	470,477	145,817
Securities lending obligations	—	—	—	3,135,116
Benefits payable	—	1,174,428	1,174,428	1,774,005
Current portion of long-term obligations	1,166,504	1,092,922	2,259,426	1,476,491
Other current liabilities	649,978	280,884	930,862	1,416,962
Total current liabilities	28,665,847	3,745,371	32,411,218	11,313,970
Noncurrent liabilities:				
Loans payable	707,805	—	707,805	—
Benefits payable	—	1,007,709	1,007,709	5,574,981
Lottery prizes and annuities	—	2,108,355	2,108,355	—
Compensated absences payable	1,419,312	16,743	1,436,055	236,635
Certificates of participation, commercial paper and other borrowings	529,752	3,937,426	4,467,178	378,898
Capital lease obligations	3,431,090	—	3,431,090	1,047,503
General obligation bonds payable	21,606,587	3,107,800	24,714,387	—
Revenue bonds payable	752,040	8,547,160	9,299,200	10,847,367
Other noncurrent liabilities	3,002,411	434,619	3,437,030	677,620
Total noncurrent liabilities	31,448,997	19,159,812	50,608,809	18,763,004
Total liabilities	**60,114,844**	**22,905,183**	83,020,027	**30,076,974**
NET ASSETS				
Investment in capital assets, net of related debt	10,983,863	905,632	11,889,495	6,616,466
Restricted:				
Nonexpendable	—	—	—	807,646
Expendable	6,717,078	7,793,710	14,510,788	6,128,394
Unrestricted	(19,417,429)	15,567	(19,401,862)	4,773,499
Total net assets	**(1,716,488)**	**8,714,909**	6,998,421	**18,326,005**
Total liabilities and net assets	**$ 58,398,356**	**$ 31,620,092**	$ 90,018,448	**$ 48,402,979**

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

Statement of Activities

Year Ended June 30, 2002
(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	$ 7,973,649	$ 4,126,078	$ 1,076,161	$ —
Education	45,882,706	2,323,881	4,627,628	—
Health and human services	53,056,652	2,114,441	26,572,426	—
Resources	3,594,345	1,246,058	258,428	—
State and consumer services	1,014,797	568,186	5,167	—
Business and transportation	7,532,507	2,810,411	1,094,250	1,584,290
Correctional programs	5,803,243	12,915	378,905	—
Tax relief	3,672,030	2,604	—	—
Interest on long-term debt	1,747,104	—	—	—
Total governmental activities	130,277,033	13,204,574	34,012,965	1,584,290
Business-type activities:				
Housing Loan	217,523	222,086	—	—
Electric Power	4,241,000	4,241,000	—	—
Water Resources	770,351	761,222	—	—
Public Building Construction	294,818	320,220	—	—
State Lottery and payments for education	2,913,051	2,966,270	—	—
Unemployment Programs	8,900,546	7,799,776	—	—
High Technology Education	38,415	44,127	—	—
Toll Facilities	26,058	5,933	1,545	—
State University Dormitory Building Maintenance and Equipment	168,513	187,921	—	—
School Building Aid	29,837	24,348	—	—
Public Employees' Benefits	1,760,926	1,682,323	—	—
Other Enterprise Programs	142,556	131,152	—	—
Total business-type activities	19,503,594	18,386,378	1,545	—
Total primary government	**$ 149,780,627**	**$ 31,590,952**	**$ 34,014,510**	**$ 1,584,290**
Component units:				
University of California	$ 16,257,634	$ 9,551,837	$ 3,209,669	$ 249,166
State Compensation Insurance Fund	4,414,039	4,300,172	—	—
California Housing Finance Agency	568,607	586,168	80,983	—
Other Component Units	622,195	352,883	—	1,736
Total component units	**$ 21,862,475**	**$ 14,791,060**	**$ 3,290,652**	**$ 250,902**

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

Transfers

Nonoperating grants and gifts

Total general revenues and transfers

Change in net assets

Net assets, July 1, 2001 (restated)

Net assets, June 30, 2002

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

Net (Expenses) Revenue and Changes in Net Assets			
Primary Government			
Governmental Activities	**Business-Type Activities**	**Total**	**Component Units**
$ (2,771,410)		$ (2,771,410)	
(38,931,197)		(38,931,197)	
(24,369,785)		(24,369,785)	
(2,089,859)		(2,089,859)	
(441,444)		(441,444)	
(2,043,556)		(2,043,556)	
(5,411,423)		(5,411,423)	
(3,669,426)		(3,669,426)	
(1,747,104)		(1,747,104)	
(81,475,204)		(81,475,204)	
	$ 4,563	4,563	
	—	—	
	(9,129)	(9,129)	
	25,402	25,402	
	53,219	53,219	
	(1,100,770)	(1,100,770)	
	5,712	5,712	
	(18,580)	(18,580)	
	19,408	19,408	
	(5,489)	(5,489)	
	(78,603)	(78,603)	
	(11,404)	(11,404)	
	(1,115,671)	(1,115,671)	
(81,475,204)	**(1,115,671)**	(82,590,875)	
			$ (3,246,962)
			(113,867)
			98,544
			(267,576)
			(3,529,861)
33,025,783	—	33,025,783	—
26,026,927	—	26,026,927	—
4,564,596	—	4,564,596	—
1,599,064	—	1,599,064	—
2,882,163	—	2,882,163	—
790,514	—	790,514	—
375,495	—	375,495	—
13,475	(13,475)	—	—
—	—	—	3,861,552
69,278,017	**(13,475)**	69,264,542	**3,861,552**
(12,197,187)	(1,129,146)	(13,326,333)	331,691
10,480,699	**9,844,055**	20,324,754	**17,994,314**
$ (1,716,488)	**$ 8,714,909**	$ 6,998,421	**$ 18,326,005**

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

Fund Financial Statements

Balance Sheet

Governmental Funds

June 30, 2002
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
ASSETS					
Cash and pooled investments	$ 597,266	$ 281,082	$ 1,693,981	$ 10,440,101	$ 13,012,430
Investments	—	—	—	403,289	403,289
Receivables (net)	5,581,753	41,321	441,263	855,566	6,919,903
Due from other funds	6,902,223	1,555	1,067,942	2,122,442	10,094,162
Due from other governments	522,814	7,203,040	19,667	138,220	7,883,741
Food stamps	—	399,415	—	—	399,415
Interfund receivables	76,991	—	180,000	242,345	499,336
Loans receivable	110,446	42,743	—	2,924,206	3,077,395
Other assets	1,231	—	9,149	61,860	72,240
Total assets	**$ 13,792,724**	**$ 7,969,156**	**$ 3,412,002**	**$ 17,188,029**	$ 42,361,911
LIABILITIES					
Accounts payable	$ 2,166,237	$ 784,399	$ 390,315	$ 1,353,239	$ 4,694,190
Due to other funds	558,232	5,266,327	34,097	1,108,849	6,967,505
Due to component units	166,985	—	163	90,653	257,801
Due to other governments	2,951,367	1,463,481	296,158	1,006,816	5,717,822
Deferred revenue	—	399,415	—	4,119	403,534
Interfund payables	945,805	—	—	225,782	1,171,587
Tax overpayments	2,615,029	—	—	9,029	2,624,058
Deposits	1,049	—	6,600	61,440	69,089
Contracts and notes payable	7,500,000	—	—	2,264	7,502,264
Advance collections	31,885	2,744	20,103	201,371	256,103
Interest payable	6,514	—	—	7,292	13,806
Other liabilities	371,203	8,818	116,432	599,974	1,096,427
Total liabilities	**17,314,306**	**7,925,184**	**863,868**	**4,670,828**	30,774,186
FUND BALANCES					
Reserved for:					
Encumbrances	1,450,879	—	2,101,873	4,803,331	8,356,083
Interfund receivables	76,991	—	180,000	242,345	499,336
Loans receivable	110,446	42,743	—	2,924,206	3,077,395
Continuing appropriations	827,316	—	1,268,587	3,556,278	5,652,181
Unreserved, reported in:					
General Fund	(5,987,214)	—	—	—	(5,987,214)
Special revenue funds	—	1,229	(1,002,326)	1,447,723	446,626
Capital projects funds	—	—	—	(456,682)	(456,682)
Total fund balances (deficits)	**(3,521,582)**	**43,972**	**2,548,134**	**12,517,201**	11,587,725
Total liabilities and fund balances	**$ 13,792,724**	**$ 7,969,156**	**$ 3,412,002**	**$ 17,188,029**	

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	$	**11,587,725**
Amounts reported for governmental activities in the Statement of Net Assets are different because:		
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.		16,912,102
Other long-term assets are not available to pay for current-period expenditures and, therefore, are not reported.		779,631
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.		697,896
Deferred issue costs are reported as current expenditures in the funds. However, deferred issue costs are amortized over the life of the bonds and are included in the governmental activities in the Statement of Net Assets.		8,057
Bonds issued by the State are not due and payable in the current period and therefore are not reported in the funds.		(23,223,061)
Long-term liabilities are not due and payable in the current period and, therefore, are not reported in the funds.		(8,478,838)
Net assets of governmental activities	**$**	**(1,716,488)**

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

Statement of Revenues, Expenditures, and Changes in Fund Balances

Governmental Funds

Year Ended June 30, 2002
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
REVENUES					
Personal income taxes	$ 32,874,734	$ —	$ —	$ —	$ 32,874,734
Sales and use taxes	21,348,052	—	2,281,252	2,277,814	25,907,118
Corporation taxes	4,553,105	—	—	—	4,553,105
Insurance taxes	1,599,064	—	—	—	1,599,064
Other taxes	1,434,999	—	—	1,603,112	3,038,111
Intergovernmental	4,177	35,595,982	—	1,227,771	36,827,930
Licenses and permits	48,346	—	698,637	2,156,875	2,903,858
Natural resources	15,363	—	—	29,050	44,413
Charges for services	124,927	—	124,738	604,209	853,874
Fees	246,202	—	—	4,363,486	4,609,688
Penalties	39,002	1,272	—	373,948	414,222
Investment and interest	768,452	—	57,273	354,050	1,179,775
Other	886,452	—	56,896	1,970,811	2,914,159
Total revenues	**63,942,875**	**35,597,254**	**3,218,796**	**14,961,126**	117,720,051
EXPENDITURES					
Current:					
General government	2,472,796	997,653	10,796	4,286,376	7,767,621
Education	36,962,138	4,898,983	956	3,461,944	45,324,021
Health and human services	21,457,530	24,587,264	—	7,098,179	53,142,973
Resources	1,654,369	151,084	12	1,916,264	3,721,729
State and consumer services	586,310	5,350	—	499,348	1,091,008
Business and transportation	91,711	2,678,523	3,591,034	2,131,889	8,493,157
Correctional programs	5,195,339	378,733	—	18,961	5,593,033
Tax relief	2,790,125	—	—	881,905	3,672,030
Capital outlay	274,955	—	2,068	1,377,471	1,654,494
Debt service:					
Principal retirement	1,158,380	—	—	63,304	1,221,684
Interest and fiscal charges	1,257,056	—	919	160,905	1,418,880
Total expenditures	**73,900,709**	**33,697,590**	**3,605,785**	**21,896,546**	133,100,630
Excess (deficiency) of revenues over (under) expenditures	(9,957,834)	1,899,664	(386,989)	(6,935,420)	(15,380,579)
OTHER FINANCING SOURCES (USES)					
Proceeds from general obligation bonds, commercial paper, and capital leases	274,955	—	2,423	5,289,611	5,566,989
Proceeds from refunding long-term debt	—	—	53,975	1,051,050	1,105,025
Payment to refunding escrow agent	—	—	(53,975)	(1,051,050)	(1,105,025)
Payment to refund commercial paper	—	—	—	(2,396,600)	(2,396,600)
Operating transfers in	1,209,676	1,189	7,057	4,730,996	5,948,918
Operating transfers out	(2,626,694)	(1,920,923)	(13,108)	(1,394,058)	(5,954,783)
Total other financing sources (uses)	**(1,142,063)**	**(1,919,734)**	**(3,628)**	**6,229,949**	3,164,524
Net change in fund balances	(11,099,897)	(20,070)	(390,617)	(705,471)	(12,216,055)
Fund balances, July 1, 2001	**7,578,315**	**64,042**	**2,938,751** *	**13,222,672** *	23,803,780
Fund balances (deficits), June 30, 2002	**$ (3,521,582)**	**$ 43,972**	**$ 2,548,134**	**$ 12,517,201**	$ 11,587,725

* 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	$ **(12,216,055)**
Amounts reported for governmental activities in the Statement of Activities are different because:	
Govermmental 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.	2,438,591
Revenues in the Statement of Activities that do not provide current financial resources are not reported as revenues in the funds.	178,496
Bond proceeds and other noncurrent financing instruments provide current financial resources to governmental funds by issuing 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. This is the amount by which proceeds exceed repayments.	(2,054,253)
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.	(652,834)
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.	108,868
Change in net assets of governmental activities	**$ (12,197,187)**

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

Balance Sheet

Proprietary Funds

June 30, 2002
(amounts in thousands)

	Business-Type Activities – Enterprise Funds		
	Housing Loan	Electric Power	Water Resources
ASSETS			
Current assets:			
Cash and pooled investments	$ 532,031	$ 2,119,000	$ 244,689
Cash and pooled investments – restricted	2,789	—	—
Amount on deposit with U.S. Treasury	—	—	—
Investments	—	10,000	—
Investments – restricted	34,536	—	—
Receivables (net)	16,578	—	89,120
Due from other funds	4,031	33,000	3,554
Due from other governments	—	—	—
Prepaid items	—	—	—
Inventories	—	—	8,225
Recoverable power costs (net)	—	1,318,000	—
Other current assets	—	—	12,214
Total current assets	589,965	3,480,000	357,802
Noncurrent assets:			
Restricted assets:			
Cash and pooled investments	—	—	157,353
Investments	—	—	45,592
Investments	375,410	—	—
Net investment in direct financing leases	—	—	—
Receivables	—	—	—
Interfund receivables	—	—	91,516
Loans receivable	2,342,198	—	38,407
Recoverable power costs (net)	—	7,263,000	—
Deferred charges	24,291	—	1,384,344
Capital assets:			
Land	443	—	—
Buildings and other depreciable property	15,590	—	4,433,677
Less: accumulated depreciation	(10,472)	—	(1,413,705)
Construction in progress	—	—	106,855
Other noncurrent assets	7,802	—	—
Total noncurrent assets	2,755,262	7,263,000	4,844,039
Total assets	**$ 3,345,227**	**$ 10,743,000**	**$ 5,201,841**

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
$ —	$ 280,728	$ 649,500	$ 1,009,114	$ 4,835,062	$ 509,351
92,309	—	—	25,658	120,756	—
—	—	5,951,533	—	5,951,533	—
—	347,586	—	835,486	1,193,072	—
—	—	—	—	34,536	—
—	115,437	91,878	34,662	347,675	10,022
120,109	7,293	62,536	24,039	254,562	346,852
—	—	158,153	19,053	177,206	4,795
—	739	4,184	3,017	7,940	36,363
—	3,828	—	1,939	13,992	95,043
—	—	—	—	1,318,000	—
—	—	—	3,036	15,250	10,474
212,418	755,611	6,917,784	1,956,004	14,269,584	1,012,900
192,680	—	—	24,904	374,937	—
13,990	—	—	36,340	95,922	—
—	2,415,652	—		2,791,062	—
4,377,696	—	—	436,246	4,813,942	—
—	—	36,431	—	36,431	—
—	—	—	2,444	93,960	—
—	—	—	184,422	2,565,027	—
—	—	—	—	7,263,000	—
47,697	932	—	2,418	1,459,682	—
—	4,923	105	829	6,300	231
—	131,343	9,864	2,257,421	6,847,895	1,167,229
—	(100,914)	(3,522)	(1,120,621)	(2,649,234)	(670,758)
326,464	—	—	—	433,319	3,065
—	—	—	9,786	17,588	—
4,958,527	2,451,936	42,878	1,834,189	24,149,831	499,767
$ 5,170,945	**$ 3,207,547**	**$ 6,960,662**	**$ 3,790,193**	$ 38,419,415	**$ 1,512,667**

(continued)

Balance Sheet

Proprietary Funds (continued)

June 30, 2002
(amounts in thousands)

	Business-Type Activities – Enterprise Funds		
	Housing Loan	Electric Power	Water Resources
LIABILITIES			
Current liabilities:			
Accounts payable	$ —	$ 397,000	$ 60,831
Due to other funds	2,906	—	60,931
Due to other governments	—	—	82,843
Deferred revenue	—	—	—
Deposits	—	—	—
Contracts and notes payable	—	—	—
Advance collections	—	—	—
Interest payable	44,653	1,000	20,049
Benefits payable	—	—	—
Current portion of long-term obligations	72,315	—	113,514
Other current liabilities	—	—	172
Total current liabilities	119,874	398,000	338,340
Noncurrent liabilities:			
Interfund payables	—	6,496,000	—
Benefits payable	24,709	—	—
Lottery prizes and annuities	—	—	—
Compensated absences payable	—	—	—
Certificates of participation, commercial paper and other borrowings	66,735	3,849,000	—
Capital lease obligations	—	—	—
General obligation bonds payable	2,278,210	—	822,090
Revenue bonds payable	544,615	—	2,360,045
Other noncurrent liabilities	—	—	432,119
Total noncurrent liabilities	2,914,269	10,345,000	3,614,254
Total liabilities	**3,034,143**	**10,743,000**	**3,952,594**
NET ASSETS			
Investment in capital assets, net of related debt	5,561	—	234,603
Restricted, expendable	305,523	—	1,014,644
Unrestricted	—	—	—
Total net assets	**311,084**	**—**	**1,249,247**
Total liabilities and net assets	**$ 3,345,227**	**$ 10,743,000**	**$ 5,201,841**

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
$ 6,435	$ 27,810	$ 45	$ 43,270	$ 535,391	$ 151,711
98,109	217,160	111,806	43,508	534,420	193,189
3,114	—	17,478	128,270	231,705	—
—	—	—	18,679	18,679	—
—	43	—	4,149	4,192	967
—	—	—	4,113	4,113	30,538
25,730	1,842	—	12,668	40,240	251,933
55,053	—	—	7,692	128,447	—
—	—	1,174,428	—	1,174,428	—
247,785	529,545	—	129,763	1,092,922	11,686
—	5,677	82,130	192,905	280,884	9,492
436,226	782,077	1,385,887	585,017	4,045,421	649,516
—	—	—	3,273	6,499,273	98,861
—	—	—	983,000	1,007,709	—
—	2,108,355	—	—	2,108,355	—
—	—	7,712	9,031	16,743	32,887
—	—	—	21,691	3,937,426	—
—	—	—	—	—	13,137
—	—	—	7,500	3,107,800	—
4,635,794	—	—	1,006,706	8,547,160	—
—	—	—	2,500	434,619	20,370
4,635,794	2,108,355	7,712	2,033,701	25,659,085	165,255
5,072,020	**2,890,432**	**1,393,599**	**2,618,718**	29,704,506	**814,771**
—	35,352	6,447	623,669	905,632	499,767
98,925	317,115	5,560,616	496,887	7,793,710	(75,820)
—	(35,352)	—	50,919	15,567	273,949
98,925	**317,115**	**5,567,063**	**1,171,475**	8,714,909	**697,896**
$ 5,170,945	**$ 3,207,547**	**$ 6,960,662**	**$ 3,790,193**	$ 38,419,415	**$ 1,512,667**

(concluded)

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

Proprietary Funds

Year Ended June 30, 2002
(amounts in thousands)

	Business-Type Activities – Enterprise Funds		
	Housing Loan	Electric Power	Water Resources
OPERATING REVENUES			
Unemployment and disability insurance	$ —	$ —	$ —
Lottery ticket sales	—	—	—
Power sales	—	4,139,000	105,325
Student tuition and fees	—	—	—
Services and sales	3,393	—	655,897
Investment and interest	211,478	—	—
Rent	—	—	—
Other	2,186	—	—
Total operating revenues	**217,057**	**4,139,000**	**761,222**
OPERATING EXPENSES			
Lottery prizes	—	—	—
Power purchases (net of recoverable power costs)	—	3,606,000	199,703
Personal services	13,304	—	163,495
Supplies	—	—	—
Services and charges	18,352	47,000	138,750
Depreciation	1,213	—	76,421
Distributions to beneficiaries	—	—	—
Interest expense	184,654	—	—
Amortization of deferred charges	—	—	14,048
Total operating expenses	**217,523**	**3,653,000**	**592,417**
Operating income (loss)	(466)	486,000	168,805
NONOPERATING REVENUES (EXPENSES)			
Donations and grants received	—	—	—
Grants provided	—	—	—
Investment and interest income	2,403	102,000	—
Interest expense and fiscal charges	—	(588,000)	(169,220)
Lottery payments for education	—	—	—
Other	2,626	—	(8,714)
Total nonoperating revenues (expenses)	**5,029**	**(486,000)**	**(177,934)**
Income (loss) before contributions and transfers	4,563	—	(9,129)
Capital contributions	—	—	—
Operating transfers in	—	—	—
Operating transfers out	—	—	—
Change in net assets	4,563	—	(9,129)
Total net assets, July 1, 2001	**306,521** *	**—**	**1,258,376** *
Total net assets, June 30, 2002	**$ 311,084**	**$ —**	**$ 1,249,247**

* 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
$ —	$ —	$ 6,876,100	$ —	$ 6,876,100	$ —
—	2,896,373	—	—	2,896,373	—
—	—	—	—	4,244,325	—
—	—	—	159,025	159,025	—
—	—	520,718	1,788,583	2,968,591	2,137,591
17,178	—	—	7,086	235,742	121
300,992	—	—	62,869	363,861	—
2,050	—	—	36,994	41,230	—
320,220	**2,896,373**	**7,396,818**	**2,054,557**	17,785,247	**2,137,712**
—	1,502,967	—	—	1,502,967	—
—	—	—	—	3,805,703	—
—	36,903	128,594	76,277	418,573	483,707
—	11,591	—	15	11,606	35,313
30,643	326,431	55,993	1,903,522	2,520,691	1,448,098
—	6,471	562	45,841	130,508	114,775
—	—	8,715,397	—	8,715,397	—
258,957	—	—	62,999	506,610	2,243
5,218	1,502	—	739	21,507	—
294,818	**1,885,865**	**8,900,546**	**2,089,393**	17,633,562	**2,084,136**
25,402	1,010,508	(1,503,728)	(34,836)	151,685	53,576
—	—	—	1,545	1,545	—
—	—	—	(4,762)	(4,762)	—
—	69,441	402,958	(31,952)	544,850	2,304
—	—	—	(1,834)	(759,054)	(14)
—	(1,027,186)	—	—	(1,027,186)	—
—	456	—	(17,117)	(22,749)	(2,834)
—	**(957,289)**	**402,958**	**(54,120)**	(1,267,356)	**(544)**
25,402	53,219	(1,100,770)	(88,956)	(1,115,671)	53,032
—	—	—	—	—	21,619
737	—	1,727	52,777	55,241	34,217
—	—	—	(68,716)	(68,716)	—
26,139	53,219	(1,099,043)	(104,895)	(1,129,146)	108,868
72,786 *	**263,896** *	**6,666,106** *	**1,276,370** *	9,844,055 *	**589,028** *
$ 98,925	**$ 317,115**	**$ 5,567,063**	**$ 1,171,475**	$ 8,714,909	**$ 697,896**

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

Statement of Cash Flows

Proprietary Funds

Year Ended June 30, 2002
(amounts in thousands)

	Housing Loan	Electric Power
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers/employers	$ 262,113	$ 4,418,000
Receipts from interfund services provided	427	—
Payments to suppliers	(51,875)	—
Payments to power suppliers	—	(5,966,000)
Payments to employees	—	—
Payments for interfund services used	(5,961)	—
Payments for lottery prizes	—	—
Claims paid to other than employees	—	—
Other receipts (payments)	44,904	—
Net cash provided by (used in) operating activities	**249,608**	**(1,548,000)**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Change in interfund payables and loans payable	—	(116,000)
Proceeds from general obligation bonds	111,325	—
Proceeds from notes payable and commercial paper	66,735	—
Proceeds from revenue bonds	117,200	—
Retirement of general obligation bonds	(180,160)	—
Retirement of notes payable and commercial paper	—	(451,000)
Retirement of revenue bonds	(139,930)	—
Interest paid on operating debt	—	(263,000)
Operating transfers in	—	—
Operating transfers out	—	—
Grants provided	—	—
Lottery payments for education	—	—
Other	—	—
Net cash provided by (used in) noncapital financing activities	**(24,830)**	**(830,000)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of intangible assets	—	—
Acquisition of capital assets	(501)	—
Proceeds from sale of capital assets	—	—
Principal paid on notes payable and commercial paper	—	—
Payment of capital lease obligations	—	—
Retirement of general obligation bonds	—	—
Proceeds from revenue bonds	—	—
Retirement of revenue bonds	—	—
Interest paid	—	—
Contributed capital	—	—
Grants received	—	—
Net cash provided by (used in) capital and related financing activities	**(501)**	**—**
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(37,795)	(10,000)
Proceeds from maturity and sale of investments	3,527	—
Change in interfund receivables and loans receivable	—	—
Earnings on investments	—	80,000
Net cash provided by (used in) investing activities	**(34,268)**	**$ 70,000**
Net increase (decrease) in cash and pooled investments	190,009	(2,308,000)
Cash and pooled investments at July 1, 2001	**344,811 ***	**4,427,000**
Cash and pooled investments at June 30, 2002	**$ 534,820**	**$ 2,119,000**

* Restated

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

Business-Type Activities – Enterprise Funds						Governmental Activities
Water Resources	Public Building Construction	State Lottery	Unemployment Programs	Nonmajor Enterprise	Total	Internal Service Funds
$ 725,161	$ 488,509	$ 2,911,201	$ 7,220,838	$ 2,021,254	$ 18,047,076	$ 1,838,971
—	—	—	—	31,588	32,015	44,792
(361,366)	(29,138)	(338,708)	(55,993)	(953,458)	(1,790,538)	(1,319,556)
—	—	—	—	—	(5,966,000)	—
(163,495)	—	(35,913)	(120,882)	(54,911)	(375,201)	(363,212)
—	—	(2,866)	—	(5,272)	(14,099)	(9,072)
—	—	(1,855,364)	—	—	(1,855,364)	—
—	—	—	(7,786,263)	(644,893)	(8,431,156)	(4,676)
—	(231,876)	356	3,269	(56,243)	(239,590)	12,031
200,300	**227,495**	**678,706**	**(739,031)**	**338,065**	(592,857)	**199,278**
—	—	—	—	—	(116,000)	144
—	—	—	—	—	111,325	—
—	—	—	—	—	66,735	—
—	—	—	—	—	117,200	—
—	—	—	—	(27,085)	(207,245)	—
—	—	—	—	—	(451,000)	—
—	—	—	—	—	(139,930)	—
—	—	—	—	—	(263,000)	—
—	737	—	4,880,721	52,777	4,934,235	34,217
—	—	—	(4,878,994)	(68,716)	(4,947,710)	—
—	—	—	—	(4,762)	(4,762)	—
—	—	(1,131,936)	—	—	(1,131,936)	—
2,954	—	—	—	(32,063)	(29,109)	—
2,954	**737**	**(1,131,936)**	**1,727**	**(79,849)**	(2,061,197)	**34,361**
—	—	—	—	—	—	(3,594)
(30,947)	(225,128)	(7,952)	—	(77,857)	(342,385)	(117,204)
—	—	300	—	7,222	7,522	873
—	—	—	—	—	—	(5,992)
—	—	—	—	—	—	(2,772)
(41,040)	—	—	—	—	(41,040)	—
163,462	231,545	—	—	234,993	630,000	—
(169,265)	(241,628)	—	—	(123,492)	(534,385)	—
(178,368)	—	—	—	(27,208)	(205,576)	(2,243)
—	—	—	—	—	—	21,619
—	—	—	—	1,545	1,545	—
(256,158)	**(235,211)**	**(7,652)**	**—**	**15,203**	(484,319)	**(109,313)**
—	—	(48,330)	—	(160,513)	(256,638)	—
13,701	12,735	347,734	461,056	—	838,753	—
7,071	—	—	—	—	7,071	—
2,318	—	21,664	402,958	30,406	537,346	2,690
23,090	**12,735**	**321,068**	**864,014**	**(130,107)**	1,126,532	**2,690**
(29,814)	5,756	(139,814)	126,710	143,312	(2,011,841)	127,016
431,856	**279,233** *	**420,542**	**522,790** *	**916,364** *	7,342,596 *	**382,335**
$ 402,042	**$ 284,989**	**$ 280,728**	**$ 649,500**	**$ 1,059,676**	$ 5,330,755	**$ 509,351**

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

Statement of Cash Flows (continued)

Proprietary Funds

Year Ended June 30, 2002
(amounts in thousands)

	Housing Loan	Electric Power
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Operating income (loss)	$ (466)	$ 486,000
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:		
Interest expense on operating debt	—	$ —
Depreciation	1,213	$ —
Accretion of capital appreciation bonds	—	—
Provisions and allowances	—	—
Accrual of deferred charges	—	—
Amortization of discounts	—	—
Amortization (recovery) of deferred charges	—	—
Other	5,245	—
Change in assets and liabilities:		
Receivables	3,676	—
Due from other funds	6,440	6,000
Due from other governments	—	—
Prepaid items	—	—
Inventories	—	—
Net investment in direct financing leases	—	—
Recoverable power costs (net)	—	(863,000)
Other assets	10,629	—
Interfund receivables	—	—
Loans receivable	245,979	—
Accounts payable	—	(1,177,000)
Due to other funds	2,883	—
Due to other governments	—	—
Deposits	—	—
Contracts and notes payable	—	—
Advance collections	—	—
Interest payable	(17,034)	—
Other current liabilities	—	—
Benefits payable	(8,957)	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	—
Capital lease obligations	—	—
Other noncurrent liabilities	—	—
Total adjustments	250,074	$ (2,034,000)
Net cash provided by (used in) operating activities	**$ 249,608**	**$ (1,548,000)**

Non-cash transactions are those portions of investing, financing, or capital activities that affected assets and liabilities but did not result in cash receipts or payments during the period.

[1]Enterprise funds had the following non-cash transactions: a. $182 million in interest accreted on annuitized lottery prizes; b. $37 million in unclaimed lottery prizes directly transferred for educational purposes; c. a $53 million unrealized gain on investment for State Lottery; and, d. a $62 million unrealized loss on investments for nonmajor enterprise funds.

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

Business-Type Activities – Enterprise Funds						Governmental Activities
Water Resources	Public Building Construction	State Lottery[1]	Unemployment Programs	Nonmajor Enterprise[1]	Total	Internal Service Funds[2]
$ 168,805	$ 25,402	$ 1,010,508	$ (1,503,728)	$ (34,836)	$ 151,685	$ 53,576
—	—	—	—	—	—	2,243
76,421	—	6,471	562	45,841	130,508	114,775
—	3,548	—	—	5,569	9,117	—
—	—	5,256	—	—	5,256	—
—	(6,173)	—	—		(6,173)	—
—	224	—	—	373	597	—
14,048	5,217	1,502	—	(2,014)	18,753	—
—	4,434	155	—	4,387	14,221	(2,156)
23,880	7	9,837	(45,513)	(12,958)	(21,071)	(3,582)
—	889	712	(28,781)	4,930	(9,810)	(12,162)
—	—	—	(135,190)	(7,755)	(142,945)	565
—	—	(312)	(4,184)	329	(4,167)	7,091
1,735	—	734	—	910	3,379	764
—	192,496	—	—	19,326	211,822	—
—	—	—	—	—	(863,000)	—
2,607	—	—	—	(205)	13,031	(942)
—	—	—	—	83	83	—
—	—	—	—	38,980	284,959	—
(28,631)	95	(4,440)	(1,387)	(1,568)	(1,212,931)	(21,898)
10,540	37	582	38,999	9,642	62,683	10,878
(58,312)	1,524	—	5,000	16,345	(35,443)	7,799
—	—	(1)	—	709	708	(1,069)
—	—	—	—	(574)	(574)	1,835
—	(2,100)	36	—	3,836	1,772	39,273
—	1,895	—	—	(256)	(15,395)	(1,391)
—	—	5,677	3,345	(1,998)	7,024	—
—	—	—	924,134	232,813	1,147,990	—
—	—	(352,398)	—	—	(352,398)	—
(6,557)	—	(5,613)	7,712	4,015	(443)	781
—	—	—	—	—	—	(2,203)
(4,236)	—	—	—	12,141	7,905	5,101
31,495	202,093	(331,802)	764,697	372,901	(744,542)	145,702
$ 200,300	**$ 227,495**	**$ 678,706**	**$ (739,031)**	**$ 338,065**	**$ (592,857)**	**$ 199,278**

(concluded)

[2]Internal service funds had installment purchases totaling approximately $8.3 million to acquire equipment.

Statement of Fiduciary Net Assets

Fiduciary Funds

June 30, 2002
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment	Agency
ASSETS				
Cash and pooled investments	$ 14,616	$ 916,879	$ 19,582,415	$ 4,562,021
Investments	625,361	270,457,943	—	—
Receivables (net)	2,217	5,663,960	—	760,757
Due from other funds	32,298	240,970	138,248	4,774,434
Due from other governments	—	1,744,311	—	358,472
Prepaid items	—	—	—	787
Interfund receivables	707,805	—	—	—
Loans receivable	—	—	—	31,892
Other assets	260,747	124,693	—	432
Total assets	**1,643,044**	**279,148,756**	**19,720,663**	**$ 10,488,795**
LIABILITIES				
Accounts payable	2,442	1,380,878	—	$ 4,306,092
Due to other funds	84	14,287	481	1,675,560
Due to component units	—	—	—	1,846
Due to other governments	345	296	137,767	3,331,696
Tax overpayments	—	—	—	7,754
Benefits payable	—	987,880	—	—
Deposits	260,747	—	—	546,111
Advance collections	—	—	—	41,916
Securities lending obligations	—	27,424,302	—	—
Interfund payables	—	—	—	27,380
Other liabilities	753,345	4,745,290	666	550,440
Total liabilities	**1,016,963**	**34,552,933**	**138,914**	**$ 10,488,795**
NET ASSETS				
Held in trust for pension benefits, pool participants, and other purposes	**$ 626,081**	**$ 244,595,823**	**$ 19,581,749**	

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

Statement of Changes in Fiduciary Net Assets

Fiduciary Funds

Year Ended June 30, 2002
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment
ADDITIONS			
Contributions:			
Employer	$ —	$ 3,573,051	$ —
Plan member	—	4,503,246	—
Total contributions	—	8,076,297	—
Investment income:			
Net appreciation (depreciation) in fair value of investments	—	(24,625,937)	—
Interest, dividends, and other investment income	17,688	10,014,572	652,097
Less: investment expense	—	(1,793,397)	—
Net investment income	17,688	(16,404,762)	652,097
Receipts from depositors	379,293	—	23,254,036
Escheat income	173,543	—	—
Operating transfers in	158,500	166	—
Other	(34,087)	10,796	—
Total additions	**694,937**	**(8,317,503)**	**23,906,133**
DEDUCTIONS			
Distributions paid and payable to participants	—	11,090,226	650,187
Refunds of contributions	—	180,056	—
Administrative expense	1,510	280,891	1,910
Payments to and for depositors	179,557	278,223	21,374,272
Operating transfers out	173,543	—	—
Total deductions	**354,610**	**11,829,396**	**22,026,369**
Change in net assets	340,327	(20,146,899)	1,879,764
Net assets, July 1, 2001	**285,754** *	**264,742,722** *	**17,701,985**
Net assets, June 30, 2002	**$ 626,081**	**$ 244,595,823**	**$ 19,581,749**

* Restated

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

Discretely Presented Component Units Financial Statements

Balance Sheet

Discretely Presented Component Units – Enterprise Activity

June 30, 2002
(amounts in thousands)

	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Nonmajor Component Units	Total
ASSETS					
Current assets:					
Cash and pooled investments	$ 132,002	$ 127,479	$ 710,099	$ 445,210	$ 1,414,790
Investments	6,352,112	166,320	1,755,146	2,819	8,276,397
Investments – restricted	—	—	—	12,422	12,422
Receivables (net)	1,418,937	476,500	243,782	11,858	2,151,077
Due from primary government	253,446	—	—	6,201	259,647
Due from other governments	120,351	—	—	11,141	131,492
Prepaid items	—	5,171	203	171	5,545
Inventories	104,906	—	—	—	104,906
Other current assets	99,440	96,534	91	11,010	207,075
Total current assets	8,481,194	872,004	2,709,321	500,832	12,563,351
Noncurrent assets:					
Restricted assets:					
Investments	—	—	—	4,893	4,893
Investments	7,708,434	8,749,793	81,281	58,061	16,597,569
Receivables (net)	253,497	—	—	36,439	289,936
Loans receivable	—	—	6,585,786	67,099	6,652,885
Deferred charges	—	35,351	46,491	1,495	83,337
Capital assets:					
Land	345,311	27,806	—	29,015	402,132
Buildings and other depreciable property	17,501,734	324,549	—	432,251	18,258,534
Less: accumulated depreciation	(8,712,221)	(151,828)	—	(118,985)	(8,983,034)
Construction in progress	2,227,229	—	—	2,428	2,229,657
Other noncurrent assets	286,313	—	17,406	—	303,719
Total noncurrent assets	19,610,297	8,985,671	6,730,964	512,696	35,839,628
Total assets	**$ 28,091,491**	**$ 9,857,675**	**$ 9,440,285**	**$ 1,013,528**	**$ 48,402,979**

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

	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Nonmajor Component Units	Total
LIABILITIES					
Current liabilities:					
Accounts payable	$ 1,102,640	$ 44,586	$ 7,858	$ 35,553	$ 1,190,637
Due to other governments	—	—	—	9,467	9,467
Deposits	760,278	—	123,379	1,034	884,691
Dividends payable	—	247,023	—	—	247,023
Deferred revenue	766,598	—	—	—	766,598
Contracts and notes payable	—	—	—	6,131	6,131
Advance collections	—	260,158	—	874	261,032
Interest payable	—	—	144,943	874	145,817
Benefits payable	—	1,774,005	—	—	1,774,005
Securities lending obligations	2,700,486	434,630	—	—	3,135,116
Current portion of long-term obligations	762,553	—	707,695	6,243	1,476,491
Other current liabilities	1,247,809	157,390	198	11,565	1,416,962
Total current liabilities	7,340,364	2,917,792	984,073	71,741	11,313,970
Noncurrent liabilities:					
Benefits payable	—	5,574,981	—	—	5,574,981
Compensated absences payable	199,659	35,937	—	1,039	236,635
Certificates of participation, commercial paper and other borrowings	378,898	—	—	—	378,898
Capital lease obligations	1,047,487	—	—	16	1,047,503
Revenue bonds payable	3,276,995	—	7,441,894	128,478	10,847,367
Other noncurrent liabilities	596,964	—	75,972	4,684	677,620
Total noncurrent liabilities	5,500,003	5,610,918	7,517,866	134,217	18,763,004
Total liabilities	**12,840,367**	**8,528,710**	**8,501,939**	**205,958**	30,076,974
NET ASSETS					
Investment in capital assets, net of related debt	6,118,273	200,527	—	297,666	6,616,466
Restricted:					
Nonexpendable	807,646	—	—	—	807,646
Expendable	3,875,026	1,128,438	938,346	186,584	6,128,394
Unrestricted	4,450,179	—	—	323,320	4,773,499
Total net assets	**15,251,124**	**1,328,965**	**938,346**	**807,570**	18,326,005
Total liabilities and net assets	**$ 28,091,491**	**$ 9,857,675**	**$ 9,440,285**	**$ 1,013,528**	$ 48,402,979

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

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

Discretely Presented Component Units – Enterprise Activity

Year Ended June 30, 2002 (amounts in thousands)	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Nonmajor Component Units	Total
OPERATING REVENUES					
Student tuition and fees	$ 1,014,124	$ —	$ —	$ —	$ 1,014,124
Grants and contracts	3,209,669	—	—	—	3,209,669
Services and sales	4,606,702	—	12,525	287,829	4,907,056
Department of Energy laboratories	3,595,374	—	—	—	3,595,374
Earned premiums (net)	—	3,595,208	—	—	3,595,208
Investment and interest	—	—	459,982	16,012	475,994
Rent	—	—	—	25,106	25,106
Other	335,637	54,517	10,978	12,861	413,993
Total operating revenues	**12,761,506**	**3,649,725**	**483,485**	**341,808**	17,236,524
OPERATING EXPENSES					
Personal services	7,663,275	134,539	12,102	93,792	7,903,708
Scholarships and fellowships	305,553	—	—	—	305,553
Supplies	1,284,576	—	—	358	1,284,934
Services and charges	256,720	57,588	59,745	230,201	604,254
Department of Energy laboratories	3,563,157	—	—	—	3,563,157
Depreciation	754,042	3,191	228	8,995	766,456
Distributions to beneficiaries	—	3,559,816	—	3,759	3,563,575
Interest expense	—	—	425,852	5,395	431,247
Amortization of deferred charges	—	466,089	1,707	—	467,796
Other	2,110,609	—	—	—	2,110,609
Total operating expenses	**15,937,932**	**4,221,223**	**499,634**	**342,500**	21,001,289
Operating income (loss)	(3,176,426)	(571,498)	(16,149)	(692)	(3,764,765)
NONOPERATING REVENUES (EXPENSES)					
Primary government and federal grants	3,180,048	—	68,973	—	3,249,021
Federal grants provided	—	—	(68,973)	—	(68,973)
Private gifts	358,315	—	—	—	358,315
Investment and interest income (loss)	(46,244)	650,447	102,683	7,279	714,165
Interest expense and fiscal charges	(256,438)	—	—	(2,695)	(259,133)
Dividends paid	—	(192,816)	—	—	(192,816)
Other	(17,020)	—	—	3,796	(13,224)
Total nonoperating revenues	**3,218,661**	**457,631**	**102,683**	**8,380**	3,787,355
Income (loss) before contributions and transfers	42,235	(113,867)	86,534	7,688	22,590
Capital contributions	249,166	—	—	1,736	250,902
Payments from primary government	269,803	—	12,010	—	281,813
Payments to primary government	—	—	—	(277,000)	(277,000)
Permanent endowments	53,386	—	—	—	53,386
Change in net assets	614,590	(113,867)	98,544	(267,576)	331,691
Total net assets, July 1, 2001	**14,636,534** *	**1,442,832**	**839,802**	**1,075,146** *	17,994,314
Total net assets, June 30, 2002	**$ 15,251,124**	**$ 1,328,965**	**$ 938,346**	**$ 807,570**	$ 18,326,005

* Restated

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

Statement of Fiduciary Net Assets

Discretely Presented Component Unit Fiduciary Activity – University of California Retirement System

June 30, 2002
(amounts in thousands)

	University of California Retirement System
ASSETS	
Investments	$ 48,898,258
Receivables (net)	680,985
Other assets	1,466,746
Total assets	**51,045,989**
LIABILITIES	
Accounts payable	675,240
Benefits payable	30,626
Securities lending obligations	7,888,319
Total liabilities	**8,594,185**
NET ASSETS	
Held in trust for benefits and other purposes	**$ 42,451,804**

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

Statement of Changes in Fiduciary Net Assets

Discretely Presented Component Unit Fiduciary Activity – University of California Retirement System

Year Ended June 30, 2002
(amounts in thousands)

	University of California Retirement System
ADDITIONS	
Contributions:	
Employer	$ 3,558
Plan member	671,810
Total contributions	675,368
Investment income:	
Net appreciation (depreciation) in fair value of investments	(5,382,805)
Interest, dividends, and other investment income	1,557,285
Less: investment expense	(207,633)
Net investment income	(4,033,153)
Total additions	**(3,357,785)**
DEDUCTIONS	
Distributions to beneficiaries	788,870
Refunds of contributions	463,740
Administrative expense	36,027
Total deductions	**1,288,637**
Change in net assets	(4,646,422)
Net assets, July 1, 2001	**47,098,226**
Net assets, June 30, 2002	**$ 42,451,804**

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, 2002, and have significantly changed the presentation of the financial statements:

GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, except for the retroactive provisions for infrastructure;

GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities*, an amendment of GASB Statement No. 34 to include public universities and colleges;

GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*, an amendment of GASB Statements No. 21 and No. 34; and

Provisions 1–11 of GASB Statement No. 38, *Certain Financial Statement Note Disclosures.*

Under the new standards, the financial report consists of the management's discussion and analysis (MD&A), basic financial statements, and required supplementary information other than the MD&A. The MD&A provides an analytical overview of the government's financial activities. The basic financial statements include: the government-wide financial statements, which separately report governmental and business-type activities of the State and activities of its component units; fund financial statements; and notes to the financial statements.

In addition, in compliance with the new standards, the State reports long-term liabilities and assets, including infrastructure assets, in the government-wide Statement of Net Assets and reports depreciation for capital assets as part of the functions' direct expenses in the Statement of Activities. The State is phasing in its reporting of state highway infrastructure, as allowed by GASB 34. All major infrastructure assets must be reported by fiscal year 2005-06. For the fund financial statements, the government is required to report separate columns for the General Fund and for other major governmental and enterprise funds. The government is also required to present a summary reconciliation between the government-wide financial statements and the fund financial statements. The fund financial statements include fiduciary funds, which are not reported in the government-wide statements.

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. Funds such as the Public Employees' Retirement Fund and the State Teachers' Retirement Fund are reported in the appropriate fiduciary funds. **Component units** are organizations that are legally separate from the State but for which the State is financially accountable, or for which the nature and significance of their 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 potential 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 blended and discretely presented component units of the State.

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, the $787 million of capital lease arrangements between the building authorities and the State has been eliminated from the financial statements. Instead, only the underlying fixed 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.

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 (SCIF), the California Housing Finance Agency (CHFA), 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 Retirement System, which is separately reported as a fiduciary fund after the fund financial statements, is a component of the comprehensive benefits package offered to employees of the university. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607-5200.

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, 2001, may be obtained from the State Compensation Insurance Fund, 1275 Market Street, San Francisco, California 94103.

CHFA was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act, as amended. CHFA'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 CHFA's governing board and has the authority to approve or modify its budget. Copies of CHFA's financial statements may be obtained from the California Housing Finance Agency, 1121 L Street, 7th Floor, Sacramento, California 95814.

State legislation created various nonmajor component units to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of

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

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

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

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

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

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

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

The *district agricultural associations*, which exhibit all of the industries, industrial enterprises, resources, and products of the state (the district agricultural associations' financial report is as of and for the year ended December 31, 2001);

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.

A **joint venture** is an entity resulting from a contractual arrangement and 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, 2002, CADA had total assets of $15.3 million, total liabilities of $8.4 million, and reserved and unreserved retained earnings of $.1 million and $5.9 million, respectively. Total revenues for the fiscal year were $6.3 million and expenses were $6.5 million, resulting in a net loss of $0.2 million. 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 can be obtained from the Capitol Area Development Authority, 1522 14th Street, Sacramento, California 95814.

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 which is not financially accountable to the State.

Chapter 854 of the Statutes of 1996 created two state-chartered, nonprofit market institutions, a Power Exchange and an Independent System Operator, to ensure a reliable supply of electricity. The Power Exchange was responsible for providing an efficient and competitive auction to meet the electricity loads of exchange customers; it was open on a nondiscriminatory basis to all electricity providers. The Independent System Operator is responsible for providing centralized control of the statewide transmission grid to ensure the efficient use and reliable operation of the transmission system. A five-member oversight board, comprised of three Governor's appointees, an appointee of the Senate Committee on Rules, and an appointee of the Speaker of the Assembly, oversees the two institutions and appoints governing boards that are broadly representative of the State's electricity users and providers. The State's accountability for these institutions does not extend beyond making the appointments. Since the primary government is not financially accountable for the Power Exchange and the Independent System Operator, the financial information of these two institutions 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.

In January 2001, the Power Exchange went bankrupt due to a spike in demand for electricity starting in the summer of 2000, coupled with a rise in the price of natural gas. Under the Governor's direction, the Department of Water Resources has assumed responsibility for purchasing a portion of the power for the customers of certain investor-owned utilities.

The **Bay Area Toll Authority,** which is not part of the State's reporting entity, was created by the California Legislature in 1997 to administer the base $1 toll on toll revenues collected from the San Francisco Bay Area's seven state-owned toll bridges and to have program oversight related to certain bridge construction projects. Additional information on the Bay Area Toll Authority may be obtained from the Metropolitan Transportation Commission, 101 Eighth Street, Oakland, California 94607.

B. Government-Wide and Fund Financial Statements

Government-wide financial statements (the statement of net assets and the statement of activities) report information on all the nonfiduciary activities of the primary government and its component units. The primary government is reported separately

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

The statement of net assets reports all of the financial and capital resources of the government as a whole in a format that displays assets equaling 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 component units. A fund is a fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds is maintained 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. Component unit statements, which follow the fiduciary fund statements, also separately report the major component units.

Governmental fund types are used primarily to account for services provided to the general public without charging directly for those services.

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, Acounting 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 *Housing Loan Fund* accounts for financing and contracts for the sale of properties to eligible California veterans.

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 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.

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

Additionally, the State reports the 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 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 activity in discretely presented component units, are not included in the government-wide 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 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, other governments, or other funds.

Discretely presented component units include the fiduciary activities of the University of California's Retirement System and enterprise activities. The enterprise activity component units are the University of California, the State Compensation Insurance Fund, the California Housing Finance Agency, and other nonmajor component units. All the activity of the discretely presented component units, except the activity of the University of California Retirement System, which is reported separately as a fiduciary fund, are reported in a separate column in the government-wide financial statements. All are reported on separate pages following the fund financial statements to emphasize that they are legally separate from the primary government. As required by GASB Statement No. 35, the University of California has adopted the accounting and financial reporting standards for public colleges and universities within the financial reporting guidelines of GASB Statement No. 34.

C. Measurement Focus and Basis of Accounting

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

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

the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental fund types are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable and available, and expenditures are recorded at the time the liabilities are incurred. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments. Other revenue sources are recorded when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months.

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

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

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

Lottery revenue and the related prize expense 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 on the economic resources measurement focus and use the full accrual basis of accounting.

D. Food Stamps

In the Federal Fund, the distribution of food stamp benefits is recognized as revenues and expenditures, as required by GAAP. Revenues and expenditures are recognized when the benefits are distributed to the recipients. Food stamp balances held by the counties are reported as an asset and are offset by deferred

revenue. Revenues, expenditures, and balances of food stamp benefits are measured based on face value.

E. Inventories

Inventories are primarily stated at the lower of average cost or market. In the government-wide financial statements, inventories for both governmental and business-type activities are expensed when consumed and unused inventories are reported as an asset on the statement of net assets. In the fund financial statements, governmental funds report inventories as expenditures when purchased. In proprietary fund types, inventories are expensed when consumed.

The discretely presented component units have inventory policies similar to those of the primary government.

F. 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.

G. 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 will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board to finance the construction of facilities and energy efficiency projects. Upon expiration of these leases, jurisdiction of the facilities and projects will be with 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.

H. 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. 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.

I. Capital Assets

Capital assets are categorized into land, state highway infrastructure, 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 category of state highway infrastructure

consists of the current year cost of additions and improvements to the State Highway System.

The value of the capital assets, including the related accumulated depreciation, is reported in the applicable governmental, business-type, or component unit activities columns in the government-wide Statement of Net Assets.

The primary government has a large collection of historical and contemporary treasures that have important documentary and artistic value. These assets are not capitalized or depreciated, because they are cultural resources and cannot reasonably be valued and/or the assets have inexhaustible useful lives. These treasures and works of art consist of buildings, furnishings, portraits and other paintings, books, statues, photographs, and miscellaneous artifacts.

In general, capital assets of the primary government are defined as assets that have a normal useful life of at least one year and a unit acquisition cost of at least $5,000. These assets are recorded at historical cost or estimated historical cost, including all costs related to the acquisition. Donated capital assets are recorded at the fair market value on the date the gift was received. Major capital asset outlays are capitalized as projects are constructed.

Buildings and other depreciable property are depreciated using the straight-line method with no salvage value for governmental activities. Buildings and other improvements are depreciated over 40 years. Equipment and personal property are depreciated over 5 years. Depreciable assets of business-type activities are depreciated using the straight line method over their estimated useful or service lives, ranging from 2 to 100 years.

California has elected to use the modified approach for capitalizing the infrastructure assets of the State Highway System. By using the modified approach, the 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. Additions and improvements are capitalized.

To comply with the prospective reporting requirements of GASB Statement No. 34, all current year additions (completed projects and purchased land) and construction work in progress (uncompleted projects) of the State Highway System are being capitalized. All costs incurred that are related to projects completed prior to the year ending June 30, 2002, will be included during the retroactive reporting phase. Retroactive reporting of the State Highway System assets will occur no later than the year ending June 30, 2006.

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.

J. 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, 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 is 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 the majority of governmental activities are immaterial and expensed in the year incurred. In some cases, issuance costs are reported as deferred charges.

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 the building authorities, which are included in the capital projects funds, the liability for revenue bonds is recorded in the respective fund.

K. 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 amounts of compensated absences that normally would be liquidated with expendable available financial resources are accrued at year-end, such as costs of academic-year faculty. The costs of the academic-year faculty represent services rendered over a ten-month period that are paid for over a 12-month period. The balance of the amounts owed for services rendered is reported as a current liability

in the General Fund. Unless it is anticipated that compensated absences will be used in excess of a normal year's accumulation, no additional liabilities are accrued. 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 a similar manner as the proprietary funds in the primary government.

L. 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 component units, and 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 outstanding principal balances of debt attributable to the acquisition, construction, or improvement of those assets.

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

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

In the fund financial statements, proprietary funds have similar categories of net assets. Governmental funds have two 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 legally 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 advances to other funds that do not represent expendable available financial resources.

Reserved for loans receivable represents the noncurrent portion of loans receivable that do 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.

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

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

M. Restatement of Beginning Fund Balances and Net Assets

Table 1 shows the restatement of the beginning fund balances and net assets.

Table 1

Restatement of Beginning Fund Balances and Net Assets
(amounts in thousands)

	Balances as of 6/30/01	Changes in Accounting Principle	Reclassification of Funds and Activities	Prior Period Adjustment	Beginning Balances 7/01/01
Governmental funds					
General Fund	$ 7,578,315	$ —	$ —	$ —	$ 7,578,315
Federal Fund	64,042	—	—	—	64,042
Transportation Construction Fund	2,932,357	—	6,394	—	2,938,751
Nonmajor governmental funds*	10,399,947	1,025	2,800,177	21,523	13,222,672
Internal service funds	605,578	—	(16,550)	—	589,028
Enterprise funds					
Housing Loan Fund	310,860	—	(4,339)	—	306,521
Water Resources Fund	984,344	—	—	274,032	1,258,376
Public Building Construction Fund	—	—	75,110	(2,324)	72,786
State Lottery Fund	—	263,896	—	—	263,896
Unemployment Programs Fund	—	7,009	6,659,097	—	6,666,106
Nonmajor enterprise funds**	2,428,588	(425,227)	(726,991)	—	1,276,370
Fiduciary funds					
Expendable trust funds	13,984,872	—	(13,984,872)	—	—
Private purpose trust funds	—	—	285,754	—	285,754
Pension and other employee benefit trust funds	259,774,161	—	4,968,561	—	264,742,722
Investment Trust Fund	17,701,985	—	—	—	17,701,985
Total primary government	**$ 316,765,049**	**$ (153,297)**	**$ 62,341**	**$ 293,231**	**$ 316,967,324**
Component units					
University of California Retirement System	$ 47,098,226	$ —	$ —	$ —	$ 47,098,226
University of California	23,089,436	(8,452,902)	—	—	14,636,534
State Compensation Insurance Fund	1,442,832	—	—	—	1,442,832
California Housing Finance Agency	839,802	—	—	—	839,802
Nonmajor component units	1,036,691	—	38,455	—	1,075,146
Total component units	**$ 73,506,987**	**$ (8,452,902)**	**$ 38,455**	**$ —**	**$ 65,092,540**

* Includes all capital projects funds and all special revenue funds except the Federal Fund and the Transportation Construction Fund.
** Includes all enterprise funds except the Housing Loan Fund, the Water Resources Fund, the Public Building Construction Fund, the State Lottery Fund, and the Unemployment Programs Fund.

N. 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 budget adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated revenues.

Under the State Constitution, money may be drawn from the treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations and establish the legal level of control at the appropriation level for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders by the Governor.

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

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

B. Legal Compliance

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

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

body, has been established in the Budget Act at the appropriation level for the annual operating budget.

NOTE 3. DEPOSITS AND INVESTMENTS

The State reports 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). There is a single portfolio of investments, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below. In addition, certain programs have the authority to separately invest their funds.

The State's pooled investment program and certain other programs of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to have investments in United States government securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, mortgage loans and notes, other debt securities, repurchase agreements, reverse repurchase agreements, equity securities, real estate, mutual funds, 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, the discretely presented component units' cash and pooled investments were approximately 3.1% 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. The State Treasurer's Office maintains cash deposits certain banks where the income earned on the deposits compensates the banks for services and uncleared checks that are deposited in the pooled investment program's accounts.

All demand and time deposits held by financial institutions as of June 30, totaling approximately $6.1 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 collateral pledged for demand and time deposits to be deposited with the State Treasurer.

As of June 30, the State Treasurer's Office had amounts on deposit with fiscal agents totaling $37 million. This represents a

compensating balance account designed to provide sufficient earnings to cover fees for custodial services and system maintenance. Most of 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 all securities in the State Treasurer's Office pooled investment program is based on quoted market prices. As of June 30, the average remaining life of the securities in the pooled money investment program administered by the State Treasurer's Office was approximately 244 days.

The Pooled Money Investment Board provides regulatory oversight over the State Treasurer's pooled investment program. The purpose of the board is to design an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested 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 temporarily idle money available for investment. The State Treasurer is charged with making the actual investment transactions for this investment program. This program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits of 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, 2002, this difference was immaterial to the valuation of the program. The pool is run with a "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 money 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, they are part of the State's reporting entity. The remaining participation in 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. The earnings on the investments related to those funds are legally required to be assigned to the State's General Fund. Most

of the $355 million in interest revenue received by the General Fund from the pooled money investment program is 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 on a quarterly basis 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 method differs from the fair value method used to value investments in these financial statements, because 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. Since the total difference between the fair values of the investments in the pool and the values 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 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.

The fair value, the ranges of interest rates, and the maturity dates of each major investment classification in the State Treasurer's pooled investment program are summarized in Table 2.

As of June 30, floating rate notes and mortgage-backed assets comprised less than 3.1% of the pooled investments. For the floating-rate notes in the portfolio, the interest received by the State Treasurer's pooled investment program rises or falls as the underlying index rate rises or falls. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio is such that it hedges the portfolio against the risk of increasing interest rates. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs). A REMIC is a security backed by a pool of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule.

The California Government Code allows the State Treasurer's Office to enter into repurchase agreements as part of its pooled investment program. A repurchase agreement consists of two simultaneous transactions. One is the purchase of securities by the State Treasurer's Office from a bank or dealer. The other is a commitment by the bank or dealer to repurchase the securities from the State

Treasurer's Office at the same price, plus interest, at a mutually agreed-upon future date. As the investor, the State is protected by underlying specific government securities, which are pledged as collateral during the length of the investment. During the year ended June 30, the State Treasurer's Office entered into 29 repurchase agreements, with a carrying value of approximately $4.4 billion. As of June 30, the State Treasurer's Office did not have any repurchase agreements outstanding.

The California Government Code allows the State Treasurer's Office to enter into reverse repurchase agreements as part of its pooled investment program. A reverse repurchase agreement is a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The market value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in market value of the securities. If the dealers defaulted on their obligations to resell these securities to the State Treasurer's Office or provide securities or cash of equal value, the State Treasurer's pooled investment program would suffer an economic loss equal to the difference between the market value plus the accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the year ended June 30, the State Treasurer's Office entered into 29 reverse repurchase agreements by temporarily selling investments with a carrying value of approximately $3.3 billion. The maturities of investments made with the proceeds from reverse repurchase agreements are matched to the maturities of the agreements. As of June 30, the State Treasurer's Office did not have any reverse repurchase agreements outstanding.

Enterprise funds, special revenue funds, fiduciary funds, and a building authority in the capital projects funds also make separate investments, which are presented at fair value. The fiduciary funds include pension and other employee benefit trust funds that comprise the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS). CalPERS and CalSTRS had $265.8 billion (96%) of these separately invested funds.

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

The fair value of CalPERS' investments in securities is 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 at cost plus accrued interest, which approximates market value when market value is not available. For investments where no readily ascertainable market value exists, management, in consultation with its investment advisors, has determined 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. Futures and options with a negative fair value of approximately $142 million were held for investment purposes as of June 30, 2002. 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. Forward foreign currency exchange contracts are used primarily to hedge against changes in exchange rates related to foreign securities. As of June 30, 2002 CalPERS had approximately a negative $141 million net exposure to loss from forward foreign currency exchange transactions related to the approximately $32.0 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.

The fair value of investments for CalSTRS is generally based on published market prices and quotations from major investment firms. 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 on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Real estate equity investment fair value represents the most recent appraisals. Short-term investments are reported at cost or amortized cost, which approximates fair value.

Purchases and sales of debt securities, equity securities, and short-term investments by CalSTRS are recorded on the trade date. Real estate equity transactions are recorded on the settlement date.

The State Constitution, state statutes, and agency 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 have been contracted to lend domestic and international equity and debt securities. All securities loans can be terminated on demand by the lender or the borrower. 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, for both CalPERS and CalSTRS. As of June 30, there was no credit risk of exposure to borrowers because the amount of collateral held exceeded the amounts owed by the borrowers. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The contracts with the securities lending agents require them to indemnify CalPERS and CalSTRS if the borrowers fail to return the securities (and if the collateral is not sufficient to replace the securities loaned) or if the borrowers fail to pay for income distributions by the securities' issuers while the securities are on loan.

For CalPERS, the average term of the overall loans managed by its four securities lending agents was 37 days, 19 days, 30 days, and 30 days, respectively. In accordance with CalPERS investment guidelines, the cash collateral was invested in short-term investment funds that, at June 30, 2002, had weighted average maturities of 91 days, 141 days, and 51 days, respectively, for three of the four portfolios. For one portfolio, a weighted average maturity was not applicable.

For CalSTRS, cash collateral received on each security loan was invested in short-term investments that, at June 30, 2002, had a weighted average maturity of less than 90 days.

As of June 30, the State, including discretely presented component units, had investments in securities lending agreements, real estate, investment contracts, mutual funds, and other investments totaling $78.1 billion. These investments are not subject to classification. All remaining investments reported as of June 30 are categorized in three categories of credit risk:

1. Insured or registered, or securities held by the State or its agent in the State's name;

2. Uninsured and unregistered, with securities held by the counterparty's trust department or by an agent in the State's name; and

3. Uninsured and unregistered, with securities held by the counterparty, its trust department, or an agent, but not in the State's name.

The types of investments reported at year-end are representative of the types of investments made during the year. Furthermore, the credit risk associated with the investments reported at year-end is representative of the credit risk associated with investments made during the year.

Table 2 presents the risk categories of the primary government as of June 30.

Table 2

Schedule of Investments – Primary Government
June 30, 2002
(amounts in thousands)

	Interest Rates*	Maturity	Category 1	Category 2	Category 3	Total Fair Value**
Pooled investments ***						
U.S. government securities	3.30 – 4.55	1 day – 5 years	$ 18,675,452	$ —	$ —	$ 18,675,452
Negotiable certificates of deposit	1.74 – 3.66	1 day – 1 year	5,805,248	—	—	5,805,248
Commercial paper	1.70 – 3.62	1 day – 180 days	12,199,561	—	—	12,199,561
Corporate bonds	3.53 – 4.65	1 day – 5 years	2,491,288	—	—	2,491,288
Bank notes	1.74 – 3.66	1 day – 1 year	1,250,066	—	—	1,250,066
Total pooled investments			**40,421,615**	**—**	**—**	**40,421,615**
Separately invested funds subject to categorization						
Equity securities			121,740,798	—	—	121,740,798
Securities lending collateral			27,424,302	—	—	27,424,302
Mortgage loans and notes			509	—	—	509
U.S. government and agencies			3,283,357	297,225	—	3,580,582
Debt securities			56,789,363	—	—	56,789,363
Commercial paper			868,727	—	—	868,727
Corporate bonds			5,165	102,495	—	107,660
Other investments			632,055	42,983	—	675,038
Total separately invested funds subject to categorization			**210,744,276**	**442,703**	**—**	**211,186,979**
Separately invested funds not subject to categorization						
Investments held by broker-dealers under securities loans with cash collateral						27,210,503
Real estate						17,463,410
Venture capital and private equity funds						6,612,758
Investment contracts						2,687,509
Mutual funds						2,806,232
Insurance contracts						10,547
Other						7,623,247
Total separately invested funds not subject to categorization						**64,414,206**
Total investments			**$ 251,165,891**	**$ 442,703**	**$ —**	**316,022,800**
Fiduciary fund investments						
Less: Investment trust fund						19,582,415
Less: Private purpose trust funds						625,361
Less: Pension and other employee benefit trust funds						270,457,943
Total government-wide investments						**25,357,081**
Less: Current government-wide investments						22,470,097
Total noncurrent government-wide investments						**$ 2,886,984**

* These interest rates represent high and low monthly averages for each investment type during the year.
** Fair value reported except for $391 million for investment contracts reported at cost in two enterprise funds.
*** Approximately 3.1% of the pooled investments are investments of discretely presented component units.
For separately invested funds of discretely presented component units, see Table 3.

The investments of the University of California, a discretely presented component unit including the University of California Retirement System (UCRS), are stated at fair value. Investments

authorized by the regents include equity securities, fixed-income securities, and a domestic and foreign indexed fund. The equity portion of the investment portfolio may include both domestic and foreign common and preferred stocks, along with a modest exposure to private equities. Private equities include venture capital partnerships, buy-outs, and international funds. The fixed-income portion of the investment portfolio may include both domestic and foreign securities, along with certain AAA-rated mortgage-backed securities. These mortgage-backed securities are used to diversify the portfolio and reduce market risk exposure. Where donor agreements place constraints on allowable investments, assets associated with endowment and similar funds are invested in accordance with the terms of the agreements.

A portion of the cash and pooled investments of the State Compensation Insurance Fund (SCIF), the California Housing Finance Agency (CHFA), and nonmajor component units is invested in the State Treasurer's pooled investment program. Additionally, state law, bond resolutions, and investment policy resolutions allow these component units to invest in U.S. government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, and other investments.

The University of California participates in a securities lending program as a means to augment income. Securities are loaned to select brokerage firms for which collateral is received in excess of the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U. S. government or its agencies, or the sovereign or provincial debt of foreign countries. Collateral securities cannot be pledged or sold by the university unless the borrower defaults. Loans of domestic equities and all fixed-income securities are initially collateralized at 102% of the fair value of 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 securities lent. The university receives interest and dividends during the loan period as well as a fee from the brokerage firm. Securities on loan for cash collateral are not considered to be categorized. As of June 30, the university had no credit risk 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, as an agent for the university, in a

short-term investment pool in the university's name, with guidelines approved by the treasurer of the board of regents. As of June 30, the securities in this pool had a weighted average maturity of 172 days.

The State Department of Insurance, which administers SCIF, permits insurance companies to lend a certain portion of their 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 approximately 102% of the fair value of securities loaned. Collateral securities received are not permitted to 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, 2001, with maturities matching the related loans. Interest income on these investments is shared by the borrower, the custodian bank, and SCIF

CHFA entered into interest-rate swap agreements to pay fixed rates of interest and receive floating rate payments. Certain swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled and/or anticipated reductions in the associated "bonds payable" category. The swap agreements are expected to reduce interest-rate risk associated with variable-rate bonds issued by CHFA. As of June 30, 2002, CHFA had interest-rate swap agreements of $2.6 billion in notional amounts. CHFA is potentially exposed to loss in the event that the counterparties are unable to perform to the terms of the agreements. However, CHFA does not anticipate nonperformance by the counterparties.

Table 3 presents risk categories of the discretely presented component unit investments as of June 30.

Table 3

Schedule of Investments – Discretely Presented Component Units
June 30, 2002
(amounts in thousands)

	Category 1	Category 2	Category 3	Total Fair Value
Separately invested funds subject to categorization				
Equity securities	$ 24,846,651	$ —	$ —	$ 24,846,651
Securities lending collateral	11,028,019	—	—	11,028,019
Mortgage loans and notes	2,199,906	—	—	2,199,906
U.S. government and agency securities	3,296,522	—	—	3,296,522
Commercial paper	43,781	—	—	43,781
Corporate bonds	16,229,501	—	—	16,229,501
Investment agreements	—	653,829	—	653,829
Other investments	1,760,680	—	—	1,760,680
Total separately invested funds subject to categorization	**59,405,060**	**653,829**	**—**	**60,058,889**
Separately invested funds not subject to categorization				
Investment agreements				1,130,927
Mutual funds				507,188
Investments held by broker-dealers under securities loans with cash collateral				10,346,437
Real estate				40,289
Venture capital and private equity funds				731,027
Insurance contracts				367,650
Mortgage loans				461,055
Other investments				146,077
Total separately invested funds not subject to categorization				**13,730,650**
Total investments	**$ 59,405,060**	**$ 653,829**	**$ —**	**73,789,539**
Less: University of California Retirement System				41,006,288
Less: University of California Retirement System securities lending transactions				7,891,970
Total enterprise activity				**24,891,281**
Less: Current Investments				8,288,819
Total noncurrent enterprise activity investments				**$ 16,602,462**

NOTE 4. DUE FROM OTHER FUNDS, DUE TO OTHER FUNDS, INTERFUND RECEIVABLES, INTERFUND PAYABLES, DUE FROM PRIMARY GOVERNMENT, AND DUE TO COMPONENT UNITS

The balances of due from other funds, due to other funds, interfund receivables, interfund payables, due from primary government, and due to component units are shown in Table 4. The total due from other funds is greater than the total due to other funds by $6.5 billion. The total interfund receivables is less than the total interfund payables by the same amount. The State of California, Department of Water Resources Electric Power Fund, issued in October and November 2002 long-term revenue bonds in the amount of $11.3 billion, and used the proceeds to repay the $6.5 billion owed to the General Fund. This situation resulted in the

General Fund's asset being reported as due from other funds, a current asset, and the Electric Power Fund's liability being reported as interfund payables, a long-term liability.

Table 4

Schedule of Due from Other Funds, Due to Other Funds, Interfund Receivables, Interfund Payables, Due from Primary Government, and Due to Component Units

June 30, 2002

(amounts in thousands)

	Due from Other Funds	Due to Other Funds	Interfund Receivables	Interfund Payables	Due from Primary Government	Due to Component Units
Governmental funds						
General Fund	$ 6,902,223	$ 558,232	$ 76,991	$ 945,805	$ —	$ 166,985
Federal Fund	1,555	5,266,327	—	—	—	—
Transportation Construction Fund	1,067,942	34,097	180,000	—	—	163
Nonmajor governmental funds	2,122,442	1,108,849	242,345	225,782	—	90,653
Total governmental funds	**10,094,162**	**6,967,505**	**499,336**	**1,171,587**	**—**	**257,801**
Internal service funds	**346,852**	**193,189**	**—**	**98,861**	**—**	**—**
Enterprise funds						
Housing Loan Fund	4,031	2,906	—	—	—	—
Electric Power Fund	33,000	—	—	6,496,000	—	—
Water Resources Fund	3,554	60,931	91,516	—	—	—
Public Building Construction Fund	120,109	98,109	—	—	—	—
State Lottery Fund	7,293	217,160	—	—	—	—
Unemployment Programs Fund	62,536	111,806	—	—	—	—
Nonmajor enterprise funds	24,039	43,508	2,444	3,273	—	—
Total enterprise funds	**254,562**	**534,420**	**93,960**	**6,499,273**	**—**	**—**
Fiduciary funds						
Private purpose trust funds	32,298	84	707,805	—	—	—
Pension and other employee benefit trust funds	240,970	14,287	—	—	—	—
Investment Trust Fund	138,248	481	—	—	—	—
Agency funds	4,774,434	1,675,560	—	27,380	—	1,846
Total fiduciary funds	**5,185,950**	**1,690,412**	**707,805**	**27,380**	**—**	**1,846**
Total primary government	**$ 15,881,526**	**$ 9,385,526**	**$ 1,301,101**	**$ 7,797,101**	**$ —**	**$ 259,647**
Component units						
University of California	$ —	$ —	$ —	$ —	$ 253,446	$ —
Nonmajor component units	—	—	—	—	6,201	—
Total component units	**—**	**—**	**—**	**—**	**259,647**	**—**
Total	**$ 15,881,526**	**$ 9,385,526**	**$ 1,301,101**	**$ 7,797,101**	**$ 259,647**	**$ 259,647**

NOTE 5. RESTRICTED ASSETS

Table 5 presents a summary of the legal restrictions on assets as of June 30. The restricted assets of the primary government are in the enterprise funds.

Table 5

Schedule of Restricted Assets
June 30, 2002
(amounts in thousands)

	Cash and Pooled Investments	Investments	Total
Primary government			
Debt service	$ 252,304	$ 116,468	$ 368,772
Construction	211,713	13,990	225,703
Operations	20	—	20
Other	31,656	—	31,656
Total primary government	**495,693**	**130,458**	**626,151**
Discretely presented component units			
Nonmajor component units – debt service	—	17,315	17,315
Total discretely presented component units	**—**	**17,315**	**17,315**
Total restricted assets	**$ 495,693**	**$ 147,773**	**$ 643,466**

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.

The minimum lease payments to be received by the State Public Works Board for the primary government are summarized in Table 6.

Table 6

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
2003	$ 394,277	$ 105,043	$ 59,487	$ 558,807
2004	390,625	105,139	59,020	554,784
2005	389,320	103,761	58,925	552,006
2006	372,764	98,816	58,670	530,250
2007	331,794	97,581	58,085	487,460
2008-2012	1,517,055	458,926	281,273	2,257,254
2013-2017	1,303,432	344,832	219,543	1,867,807
2018-2022	645,961	253,076	33,784	932,821
2023-2027	95,788	14,421	—	110,209
Total minimum lease payments	**5,441,016**	**1,581,595**	**828,787**	**7,851,398**
Less unearned income	2,132,861	614,959	289,636	3,037,456
Net investment in direct financing leases	**$ 3,308,155**	**$ 966,636**	**$ 539,151**	**$ 4,813,942**

NOTE 7. CAPITAL ASSETS

Table 7 summarizes the capital activity for the primary government as of June 30. Included in the capital activity is $4.0 billion in fixed assets related to capital leases.

Table 7

Schedule of Changes in Capital Assets — Primary Government
June 30, 2002
(amounts in thousands)

	Beginning Balance*	Additions	Deductions	Ending Balance
Governmental activities				
Capital assets not being depreciated:				
Land	$ 2,268,751	$ 701,568	$ 16,968	$ 2,953,351
State highway infrastructure	—	59,262	—	59,262
Construction in progress	1,319,641	1,366,573	155,229	2,530,985
Total capital assets not being depreciated	**3,588,392**	**2,127,403**	**172,197**	**5,543,598**
Capital assets being depreciated:				
Buildings and improvements	13,470,837	867,008	253,489	14,084,356
Infrastructure	282,341	23,223	—	305,564
Equipment and other assets	2,575,407	334,574	173,661	2,736,320
Total capital assets being depreciated	**16,328,585**	**1,224,805**	**427,150**	**17,126,240**
Less accumulated depreciation for:				
Buildings and improvements	3,013,635	426,936	209,334	3,231,237
Infrastructure	103,181	6,952	—	110,133
Equipment and other assets	1,788,759	300,764	172,924	1,916,599
Total accumulated depreciation	**4,905,575**	**734,652**	**382,258**	**5,257,969**
Total capital assets being depreciated, net	**11,423,010**	**490,153**	**44,892**	**11,868,271**
Governmental activities, capital assets, net	**$ 15,011,402**	**$ 2,617,556**	**$ 217,089**	**$ 17,411,869**
Business-type activities				
Capital assets not being depreciated:				
Land	$ 10,406	$ 105	$ 4,211	$ 6,300
Construction in progress	406,963	34,324	7,968	433,319
Total capital assets not being depreciated	**417,369**	**34,429**	**12,179**	**439,619**
Capital assets being depreciated:				
Buildings and improvements	6,687,264	112,882	65,664	6,734,482
Equipment and other assets	110,423	3,990	1,000	113,413
Total capital assets being depreciated	**6,797,687**	**116,872**	**66,664**	**6,847,895**
Less accumulated depreciation for:				
Buildings and improvements	2,455,816	129,334	32,465	2,552,685
Equipment and other assets	95,375	1,174	—	96,549
Total accumulated depreciation	**2,551,191**	**130,508**	**32,465**	**2,649,234**
Total capital assets being depreciated, net	**4,246,496**	**(13,636)**	**34,199**	**4,198,661**
Business-type activities, capital assets, net	**$ 4,663,865**	**$ 20,793**	**$ 46,378**	**$ 4,638,280**

*Restated

Table 8 summarizes the depreciation expense charged to the activities of the primary government as of June 30.

Table 8

Schedule of Primary Government Depreciation Expense
June 30, 2002
(amounts in thousands)

	Amount
Governmental activities	
General government	$ 87,742
Education	196,651
Health and human services	30,785
Resources	43,313
State and consumer services	22,514
Business and transportation	87,143
Correctional programs	151,729
Internal service funds (charged to the activities that utilize the fund)	114,775
Total depreciation expense – governmental activities	**734,652**
Business-type activities	
Enterprise	**130,508**
Total primary government	**$ 865,160**

Table 9 summarizes the capital activity for discretely presented component units as of June 30.

Table 9

Schedule of Changes in Capital Assets — Discretely Presented Component Units
June 30, 2002
(amounts in thousands)

	Beginning Balance	Additions	Deductions	Ending Balance
Capital assets, not being depreciated:				
Land	$ 378,425	$ 25,114	$ 1,407	$ 402,132
Construction in progress	1,436,781	792,876	—	2,229,657
Total capital assets not being depreciated	**1,815,206**	**817,990**	**1,407**	**2,631,789**
Capital assets being depreciated:				
Buildings and improvements	10,512,459	623,727	19,669	11,116,517
Equipment and other depreciable assets	6,559,778	553,833	261,647	6,851,964
Infrastructure	276,990	13,610	547	290,053
Total capital assets being depreciated	**17,349,227**	**1,191,170**	**281,863**	**18,258,534**
Less accumulated depreciation for:				
Buildings and improvements	4,079,694	358,704	12,445	4,425,953
Equipment and other depreciable assets	4,254,553	412,956	240,741	4,426,768
Infrastructure	121,373	9,462	522	130,313
Total accumulated depreciation	**8,455,620**	**781,122**	**253,708**	**8,983,034**
Total capital assets being depreciated, net	**8,893,607**	**410,048**	**28,155**	**9,275,500**
Capital assets, net	**$ 10,708,813**	**$ 1,228,038**	**$ 29,562**	**$ 11,907,289**

NOTE 8. LONG-TERM OBLIGATIONS

As of June 30, the primary government had long-term obligations totaling $52.9 billion. Of that amount, $2.3 billion is due within one year. The other long-term obligations for governmental activities consist of $1.9 billion for workers' compensation claims, $909 million for net pension obligations, $362 million owed for lawsuits, and the University of California pension liability of $91 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 loans payable, net pension obligations, lawsuits, and the University of California pension liability will be liquidated by the General Fund. The $435 million other long-term obligations for business-type activities is mainly for advance collections. These other long-term obligations liabilities do not have required payment schedules, or they will be paid when funds are appropriated. The changes in the long-term obligations during the year ended June 30, 2002, are summarized in Table 10.

Table 10

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

	Balance July 1, 2001		Additions	Deductions	Balance June 30, 2002	Due Within One Year	Noncurrent Liabilities
Governmental activities							
Loans payable	$ 617,208	*	$ 173,543	$ 82,946	$ 707,805	$ —	$ 707,805
Compensated absences payable	1,487,739		786,836	690,983	1,583,592	164,280	1,419,312
Certificates of participation and commercial paper	452,045		2,492,020	2,403,973	540,092	10,340	529,752
Capital lease obligations	3,574,205	*	235,533	212,202	3,597,536	166,446	3,431,090
General obligation bonds payable	20,442,250		2,982,097	1,313,525	22,110,822	504,235	21,606,587
Revenue bonds payable	814,605		—	30,590	784,015	31,975	752,040
Other long-term obligations	2,734,596	*	935,273	378,230	3,291,639	289,228	3,002,411
Totals	**$ 30,122,648**		**$ 7,605,302**	**$ 5,112,449**	**$ 32,615,501**	**$ 1,166,504**	**$ 31,448,997**
Business-type activities							
Benefits payable	$ 863,601		$ 233,082	$ 8,957	$ 1,087,726	$ 80,017	$ 1,007,709
Lottery prizes and annuities	2,844,874		—	206,974	2,637,900	529,545	2,108,355
Compensated absences payable	33,724		34,580	35,023	33,281	16,538	16,743
Certificates of participation and commercial paper	4,371,100		108,067	541,741	3,937,426	—	3,937,426
General obligation bonds payable	3,358,270		—	136,960	3,221,310	113,510	3,107,800
Revenue bonds payable	8,802,888		699,288	601,704	8,900,472	353,312	8,547,160
Other long-term obligations	437,225		2,500	5,106	434,619	—	434,619
Totals	**$ 20,711,682**		**$ 1,077,517**	**$ 1,536,465**	**$ 20,252,734**	**$ 1,092,922**	**$ 19,159,812**

*Restated

NOTE 9. CERTIFICATES OF PARTICIPATION

Debt service requirements for certificates of participation, which are financed by lease payments from governmental activities, are shown in Table 11. The certificates of participation were used to finance the acquisition and construction of state office buildings.

Table 11

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

Year Ending June 30	Principal	Interest	Total
2003	$ 10,340	$ 3,530	$ 13,870
2004	10,214	3,636	13,850
2005	10,101	3,733	13,834
2006	10,051	4,154	14,205
2007	5,483	4,154	9,637
2008-2012	27,630	20,573	48,203
2013-2017	34,408	7,058	41,466
Total	**$ 108,227**	**$ 46,838**	**$ 155,065**

Debt service requirements for certificates of participation for the University of California, a discretely presented component unit, are shown in Table 12.

Table 12

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
2003	$ 11,440	$ 17,283	$ 28,723
2004	11,975	16,692	28,667
2005	12,610	15,967	28,577
2006	13,245	15,323	28,568
2007	13,910	14,639	28,549
2008-2012	71,010	61,825	132,835
2013-2017	65,930	44,448	110,378
2018-2022	81,025	24,800	105,825
2023-2027	24,665	9,882	34,547
2028-2032	23,665	2,969	26,634
Total	**$ 329,475**	**$ 223,828**	**$ 553,303**

NOTE 10. COMMERCIAL PAPER AND OTHER BORROWINGS

The primary government has two commercial paper borrowing programs: a general obligation commercial paper program of up to

$1.5 billion, and an enterprise fund commercial paper program for the Department of Water Resources of up to $100 million. Under these programs, commercial paper may be issued at prevailing rates for periods not to exceed 270 days from the date of issuance.

To provide liquidity for the programs, the State has entered into a revolving credit agreement with commercial banks for an amount equal to the authorized amount of commercial paper.

The current agreement for the general obligation commercial paper program, effective September 15, 1999, established the existing $1.5 billion limit on the amount of outstanding notes. As of June 30, 2002, the general obligation commercial paper program had $499 million in outstanding commercial paper notes. Of this amount, $432 million was related to governmental activity and $67 million was related to business-type activity shown in the government-wide statement of net assets. The enterprise fund commercial paper program had no Department of Water Resources outstanding notes.

The proceeds from the issuance of commercial paper are restricted primarily to construction costs of general obligation bond program projects and of certain state water projects. Because the general obligation commercial paper is retired by long-term general obligation debt, it is considered a noncurrent liability.

In June 2001, the primary government received an interim loan for $4.3 billion that was used for power purchases. The financing was structured as a term loan due to be paid on or before October 31, 2001, from the proceeds of the sale of long-term revenue bonds. As bonds were not issued before October 31, 2001, the interim financing converted to a three-year term loan with quarterly principal and interest payments. The primary government made principal payments of $451 million during the year ended June 30, 2002. The term loan was paid off with bond proceeds in October 2002.

The primary government has a Revenue Bond Anticipation Note (BAN) program that consists of borrowing up to $26 million for the development and construction of housing on certain campuses of California State University. As of June 30, 2002, $22 million in outstanding BANs existed in anticipation of issuing housing revenue bonds to the public.

The University of California, a discretely presented component unit, has mortgages and other borrowings consisting of contractual obligations resulting from the acquisition of land or buildings and the construction and renovation of certain facilities. The mortgages are secured by real property. Included in mortgages and other

borrowings, which total approximately $134 million, are various unsecured financing agreements with commercial banks that total approximately $102 million.

The University of California established a $550 million commercial paper program with tax-exempt and taxable components. The program is supported by the legally available unrestricted investments balance in the University of California's Short-Term Investment Pool. Commercial paper has been issued to provide for interim financing of construction and related equipment and medical center working capital requirements. 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, 2002, outstanding tax-exempt and taxable commercial paper was $430 million and $120 million, respectively.

NOTE 11. LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30 was approximately $7.0 billion. This amount does not include any future escalation charges for real estate taxes and operating expenses. 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 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 $17 million from internal service funds and $3.6 billion from other governmental activities. The additions and deductions of capital lease obligations may be found in Note 8, Long-Term Obligations. Also reported in Note 8 are the current and noncurent portions of the capital lease obligations. Lease expenditures for the year ended June 30 amounted to approximately $783 million.

Included in the capital lease commitments are lease-purchase agreements that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency, amounting to a present value of net minimum lease payments of $3.3 billion. This amount represents 92% 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 $787 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 statements. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements.

Future minimum lease commitments of the primary government are summarized in Table 13.

Table 13

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
2003	$ 286,718	$ 5,215	$ 475,636	$ 767,569
2004	223,387	4,599	449,934	677,920
2005	158,572	4,772	434,136	597,480
2006	99,930	1,221	397,389	498,540
2007	73,298	791	351,123	425,212
2008-2012	172,214	4,019	1,588,865	1,765,098
2013-2017	74,429	—	1,357,855	1,432,284
2018-2022	9,746	—	693,811	703,557
2023-2027	683	—	110,143	110,826
2028-2032	676	—	—	676
2033-2037	3	—	—	3
2038-2042	3	—	—	3
2043-2047	3	—	—	3
Total minimum lease payments	**$ 1,099,662**	**20,617**	**5,858,892**	**$ 6,979,171**
Less amount representing interest		3,361	2,278,612	
Present value of net minimum lease payments		**$ 17,256**	**$ 3,580,280**	

The aggregate amount of discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 2002, was approximately $2.2 billion. Table 14 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 amounted to approximately $159 million for discretely presented component units.

Table 14

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

Year Ending June 30	University of California Capital	University of California Operating	State Compensation Insurance Fund Operating	Total
2003	$ 124,715	$ 70,307	$ 32,151	$ 227,173
2004	118,975	62,636	28,973	210,584
2005	111,739	52,672	24,057	188,468
2006	105,848	42,063	17,742	165,653
2007	97,820	45,806	15,236	158,862
2008-2012	469,780	67,464	53,221	590,465
2013-2017	379,923	3,342	—	383,265
2018-2022	255,061	3,375	—	258,436
2023-2027	41,666	3,754	—	45,420
2028-2032	—	4,283	—	4,283
2033-2037	—	4,877	—	4,877
2038-2042	—	2,718	—	2,718
Total minimum lease payments	**1,705,527**	**$ 363,297**	**$ 171,380**	**$ 2,240,204**
Less amount representing interest	593,326			
Present value of net minimum lease payments	**$ 1,112,201**			

NOTE 12. COMMITMENTS

As of June 30, 2002, the primary government had commitments of $4.4 billion for certain highway construction projects. These commitments are not included in the reserve for encumbrances in the Federal and Transportation Construction Funds because the future expenditures related to these commitments are expected to be reimbursed with $871 million from local governments and $3.5 billion in proceeds of approved federal grants. The ultimate liability will not accrue to the State.

The primary government had other commitments totaling $3.1 billion that are not included as a liability on the balance sheet. These commitments included loan and grant agreements that totaled approximately $810 million to reimburse other entities for construction projects for housing, school building aid, and the rail system. The constructed assets will not belong to the primary government, whose payments are contingent upon the other entities entering into construction contracts. In addition to the loan and grant commitments, the primary government had approximately $1.1 billion for seismic retrofit of toll bridges, $750 million for the construction of water projects and the purchase of power, $82 million for a crime laboratory, $66 million for traffic congestion relief, and $340 million for the maintenance and operation of the

California State Lottery's automated gaming system and its telecommunication systems and services. These are long-term projects, and all needs of the contracts 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.

The primary government has also entered into $24.3 billion in long-term contracts to purchase power that are not included as a liability on the balance sheet of the Electric Power Fund. In addition, there are variable costs that management estimates at $7.7 billion 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.

As of June 30, the discretely presented component units had other commitments that are not included as a liability on the balance sheet. The University of California had authorized construction projects totaling $2.4 billion. Other component units had outstanding commitments to provide $315 million for loans under various housing revenue bond programs and $128 million for loans to other governments for infrastructure improvements.

NOTE 13. GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds majority of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used first to support the public school system and public institutions of higher education; it can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service provided on their behalf.

General obligation bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included in the accounts 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, $11.4 billion of general obligation bonds had been authorized but not issued. This amount includes $3.8 billion that has been authorized by the applicable finance committee for future

issuance in the form of commercial paper notes. Of this amount, $499 million in general obligation indebtedness has been issued in the form of commercial paper notes, but not yet retired by long-term bonds.

In January 2002, the State Treasurer announced the State's new *Strategic Debt Management Plan*. Under this plan, the State will change how it makes payments on new general obligation bond issuances by shifting from its then-current practice of making level principal payments to making level debt service payments (principal and interest combined). In addition, the plan calls for the deferral of initial principal payments on the newly issued general obligation bonds. The plan also targets the restructuring of certain outstanding general obligation bonds to achieve one-time reductions in debt service requirements and to facilitate a faster transition to level debt service payments. Lastly, the plan includes the issuance of variable rate debt for a portion of the State's general obligation bond portfolio beginning in fiscal year 2002-03.

Information on the changes in general obligation bond debt for the year ended June 30 may be found in Note 8, Long-Term Obligations.

Table 15 shows the debt service requirements for all general obligation bonds.

Table 15

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

Year Ending	Governmental Activities			Business-Type Activities		
June 30	Interest	Principal	Total	Interest	Principal	Total
2003	$ 1,209,429	$ 504,235	$ 1,713,664	$ 184,383	$ 113,510	$ 297,893
2004	1,166,091	1,328,300	2,494,391	176,090	119,375	295,465
2005	1,085,496	1,244,954	2,330,450	167,420	134,340	301,760
2006	1,014,375	1,171,410	2,185,785	157,854	147,955	305,809
2007	945,472	1,204,445	2,149,917	147,203	176,545	323,748
2008-2012	3,729,902	5,523,623	9,253,525	565,491	832,090	1,397,581
2013-2017	2,528,216	2,923,165	5,451,381	359,939	722,955	1,082,894
2018-2022	1,770,895	3,109,860	4,880,755	205,638	445,065	650,703
2023-2027	964,358	2,945,680	3,910,038	112,451	319,955	432,406
2028-2032	263,154	2,155,150	2,418,304	35,184	172,870	208,054
2033-2037	—	—	—	1,050	36,650	37,700
Total	**$ 14,677,388**	**$ 22,110,822**	**$ 36,788,210**	**$ 2,112,703**	**$ 3,221,310**	**$ 5,334,013**

Current Year Defeasances: During the year ended June 30, 2002, the primary government issued approximately $111 million in veterans general obligation bonds, the proceeds of which were used to immediately refund approximately $111 million in outstanding general obligation bonds maturing in years 2002 and 2018 to 2025. The advance refunding reduced debt service payments by $22.6 million and resulted in an economic gain of $11 million.

On March 13, 2002, the primary government issued approximately $1.1 billion in various purpose general obligation refunding bonds to advance refund $853 million in outstanding general obligation bonds maturing in 2003, to retire $163 million of outstanding general obligation commercial paper notes, and to refund $43 million of selected general obligation bonds that matured in 2002. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for those bonds has been removed from the financial statements. This advance refunding increased overall debt service payments by approximately $1.0 billion and resulted in an economic gain of $21 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 5.5% per year over the life of the new bonds. The State Treasurer's Office executed this refunding to achieve significant one-time reductions in debt service requirements and to aid a more rapid transition to level debt service payments.

Prior Year Defeasance: In prior years, the primary government has placed the proceeds of the refunded bonds in a special irrevocable escrow trust account with the State Treasury to provide for all future debt service payments on the defeased bonds. The assets of the trust accounts and the liability for the defeased bonds are not included in the State's financial statements. As of June 30, 2002, the outstanding balance of general obligation bonds defeased in prior years was approximately $2.2 billion.

NOTE 14. REVENUE BONDS

Revenue bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included within the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of the authorities and agencies listed in the next section of this note. 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 are issued for water resources, public building construction, and certain nonmajor enterprise funds. Revenue bonds are also issued to make loans to finance the acquisition of farms and homes by California veterans.

Certain building authorities, under state law, may issue revenue bonds. These revenue bonds are in the governmental activities column of the government-wide statement of net assets. 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.

The University of California, a discretely presented component unit, issues revenue bonds to finance the construction, renovation, and acquisition of certain facilities and equipment.

Under state law, the California Housing Finance Agency (CHFA), which is a discretely presented component unit, 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 common indices such as BMA or LIBOR and is generally reset monthly.

Table 16 shows revenue bonds outstanding as of June 30.

Table 16

Schedule of Revenue Bonds Outstanding
June 30, 2002
(amounts in thousands)

Primary government	
Governmental activities	
Nonmajor governmental funds (building authorities)	$ 784,015
Total nonmajor governmental funds	**784,015**
Business-type activities	
Housing Loan	548,210
Water Resources	2,419,080
Public Building Construction	4,883,579
Nonmajor enterprise	1,049,603
Total enterprise funds	**8,900,472**
Total primary government	**9,684,487**
Discretely presented component units	
University of California	3,365,960
California Housing Finance Agency	8,148,211
Nonmajor component units	131,018
Total discretely presented component units	**11,645,189**
Total	**$ 21,329,676**

Table 17 shows the debt service requirements as of June 30, 2002. Table 17 includes certain unamortized refunding costs, premiums, discounts, and other costs that are not included in Table 16.

Table 17

Schedule of Revenue Bond Debt Service Requirements
(amounts in thousands)

Year Ending June 30	Primary Government				Discretely Presented Component Units	
	Governmental Activities		Business-Type Activities			
	Interest	Principal	Interest	Principal	Interest	Principal
2003	$ 40,551	$ 31,975	$ 471,395	$ 363,735	$ 441,196	$ 797,829
2004	39,070	33,450	453,301	367,466	407,121	276,134
2005	37,422	35,080	436,213	385,767	396,683	302,239
2006	35,655	37,155	416,442	412,015	386,390	321,946
2007	33,664	39,135	397,032	368,013	374,953	334,858
2008-2012	133,967	211,910	1,692,299	2,004,815	1,766,203	1,997,299
2013-2017	81,208	177,765	1,115,565	2,158,415	1,369,912	2,389,036
2018-2022	31,180	203,480	546,907	1,847,283	967,219	1,928,601
2023-2027	629	14,065	186,083	915,425	670,507	1,808,277
2028-2032	—	—	25,923	308,560	294,218	1,317,878
2033-2037	—	—	—	—	54,042	155,904
2038-2042	—	—	—	—	5,902	34,430
Total	**$ 433,346**	**$ 784,015**	**$ 5,741,160**	**$ 9,131,494**	**$ 7,134,346**	**$ 11,664,431**

Current Year Defeasances: For the year ended June 30, 2002, the primary government issued approximately $117 million of home purchase revenue bonds to refund approximately $117 million of outstanding revenue bonds. The proceeds of those bonds that could not be called for immediate redemption were deposited in an escrow account held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the defeased bonds. As a result, these bonds are considered to be defeased and the liabilities have been removed from the financial statements. The advance refunds reduced the debt service payments by $11 million and resulted in an economic gain of $4 million.

In May 2002, the primary government issued $160 million in Central Valley Project Water System Revenue Bonds, Series X, to advance refund $114 million of outstanding revenue bonds and redeem commercial paper borrowings of $41 million. The new proceeds of the advance refundings (after payment of underwriting refunding fees, other issuance costs, and deposits to the Debt Service Reserve Accounts) were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the advance refunded bonds. As a result, the advance refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements. The advance refunding reduced the primary government's aggregate debt service payments

by approximately $3 million over the next 20 years and resulted in an economic gain of $4 million.

On April 1, 2002, the primary government issued $9.5 million in revenue bonds to advance refund $9.2 million of outstanding California State University revenue bonds. After payment of underwriting fees, insurance, and other issuance costs, and use of original bond premium, the net proceeds were $9.7 million. These net proceeds were deposited in various escrow accounts held by the State Treasurer, as escrow agent, 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 advance refunding reduced the primary government's aggregate debt service payments by $1.4 million and resulted in an economic gain of approximately $951,000.

For the year ended June 30, 2002, CHFA, a discretely presented component unit, issued $29 million of Multifamily Housing Revenue Bonds to refund $29 million in outstanding Housing Revenue Bonds and Multi-Unit Rental Housing Revenue Bonds. CHFA considered these debt refundings to be an in-substance defeasance and, accordingly, removed the redeemed bonds and related assets from the financial statements. The refunding will decrease the debt service cash outflow for the housing bonds by approximately $10 million and result in an economic gain of approximately $8 million. The deferred loss from the extinguishment of the debt was $775,000.

Prior Year Defeasances: 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, 2002, the outstanding balance of revenue bonds defeased in prior years was approximately $1.5 billion.

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, 2002, the outstanding balance of University of California revenue bonds defeased in prior years was $665 million.

NOTE 15. FUND DEFICITS and ENDOWMENTS

A. Fund Deficits

Table 18 shows the funds that had deficits at June 30, 2002.

Table 18

Schedule of Fund Deficits
June 30, 2002
(amounts in thousands)

	Governmental Funds	Enterprise Funds	Internal Service Funds
General Fund	$ 3,521,582	$ —	$ —
Higher Education Construction	194,670	—	—
All Other Capital Projects	44,752	—	—
Public Employees' Benefits	—	180,568	—
Water Resources Revolving	—	—	14,552
Total	**$ 3,761,004**	**$ 180,568**	**$ 14,552**

B. Discretely Presented Component Units – Endowments

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, 2002, the total fair value of restricted and unrestricted endowments were $3.2 billion and $965 million, respectively. The University of California'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 $1.1 billion at June 30, 2002. 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 16. RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. Generally, the exceptions are when a bond resolution or a contract requires the primary government to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, there has been no insurance settlement in the last three years that has exceeded insurance coverage. The primary government generally does not maintain reserves. Losses are covered in the year in which the payment occurs by appropriations from each fund responsible

for payment. All claim payments are on a "pay as you go" basis with workers' compensation benefits for self-insured agencies being primarily paid by SCIF. 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 $1.9 billion as of June 30, 2002. 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 $2.4 billion is discounted to $1.9 billion, using a 4% interest rate. Of the total, $289 million is a current liability, of which $174 million is included in the General Fund, $114 million in the special revenue funds, and $1 million in the internal service funds. The remaining $1.6 billion is reported as governmental noncurrent liabilities in the government-wide statement of net assets. Changes in the claims liabilities during the year ended June 30 are shown in Table 19.

The University of California, a discretely presented component unit, is self-insured for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based upon an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 5.25% to 7.5%. The other discretely presented component units do not have any significant liabilities related to self-insurance. Changes in the self-insurance claims liabilities for the primary government and the University of California during the fiscal year ended June 30 are reported in Table 19.

Table 19

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

	Primary Government		University of California – Discretely Presented Component Unit	
	2002	2001	2002	2001
Unpaid claims, beginning	$ 1,428,500	$ 1,091,000	$ 402,800	$ 362,300
Incurred claims	829,500	617,500	262,600	247,800
Claim payments	(327,000)	(280,000)	(211,600)	(207,300)
Unpaid claims, ending	**$ 1,931,000**	**$ 1,428,500**	**$ 453,800**	**$ 402,800**

NOTE 17. NONMAJOR ENTERPRISE SEGMENT INFORMATION

Table 20 presents the condensed balance sheet, the condensed statement of revenues, expenses, and changes in net assets, and the condensed statement of cash flows for nonmajor enterprise funds. The primary sources of revenues for these funds follow.

High Technology Education: Proceeds from revenue bonds and other debt for construction and renovation of public buildings for high-technology purposes.

Toll Facilities: Toll fees collected for crossing state toll bridges, except for the fees administered by the Bay Area Toll Authority.

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

School Building Aid: Interest charged on loans to school districts for acquisition, construction, or rehabilitation of classroom facilities and income from the rental of portable classrooms to school districts.

Public Employees' Benefits: Contribution and premiums for public employee long-term care plans, and fees for managing a deferred compensation program.

Other Enterprise Programs: All other goods or services provided to the general public on a continuing basis when all or most of the cost involved is to be financed by user charges.

Table 20

Nonmajor Enterprise Funds

(amounts in thousands)

Condensed Balance Sheet

June 30, 2002

	High Technology Education	Toll Facilities
Assets		
Due from other funds	$ 11,138	$ 123
Due from other governments	—	—
Other current assets	25,658	50,763
Capital assets	—	552,147
Other noncurrent assets	499,610	560
Total assets	**$ 536,406**	**$ 603,593**
Liabilities		
Due to other funds	$ —	$ 19,829
Due to other governments	—	6,692
Other current liabilities	33,375	10,807
Noncurrent liabilities	382,433	—
Total liabilities	**415,808**	**37,328**
Net assets		
Investment in capital assets, net of related debt	—	536,661
Restricted	120,598	—
Unrestricted	—	29,604
Total net assets	**120,598**	**566,265**
Total liabilities and net assets	**$ 536,406**	**$ 603,593**

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

Year Ended June 30, 2002

Operating revenues	$ 44,127	$ 5,648
Depreciation expense	—	(18,517)
Other operating expenses	(38,415)	(2,779)
Operating income (loss)	5,712	(15,648)
Nonoperating revenues (expenses):		
Donations and grants received	—	1,545
Grants provided	—	(4,762)
Investment and interest income	—	285
Interest expense and fiscal charges	—	—
Other	—	—
Operating transfers in	—	—
Operating transfers out	(566)	—
Change in net assets	5,146	(18,580)
Beginning net assets	**115,452**	**584,845**
Ending net assets	**$ 120,598**	**$ 566,265**

Condensed Statement of Cash Flows

Year Ended June 30, 2002

Net cash provided (used) by:		
Operating activities	$ 34,695	$ 17,363
Noncapital financing activities	(566)	(4,762)
Capital and related financing activities	(33,120)	1,545
Investing activities	—	285
Net increase (decrease)	**1,009**	**14,431**
Beginning cash and cash equivalents	**49,553**	**26,972**
Ending cash and cash equivalents	**$ 50,562**	**$ 41,403**

State University Dormitory Building Maintenance and Equipment	School Building Aid	Public Employees' Benefits	Other Enterprise Programs	Total
$ 1,353	$ —	$ 2,880	$ 8,545	$ 24,039
—	1,289	17,074	690	19,053
438,347	35,203	1,019,376	343,565	1,912,912
538,456	41,021	—	6,005	1,137,629
9,524	98,423	—	88,443	696,560
$ 987,680	**$ 175,936**	**$ 1,039,330**	**$ 447,248**	**$ 3,790,193**
$ 8,535	$ —	$ 10,543	$ 4,601	$ 43,508
—	—	121,531	47	128,270
62,696	74	104,824	201,463	413,239
657,439	—	983,000	10,829	2,033,701
728,670	**74**	**1,219,898**	**216,940**	**2,618,718**
43,229	41,021	—	2,758	623,669
202,314	134,841	(180,568)	219,702	496,887
13,467	—	—	7,848	50,919
259,010	**175,862**	**(180,568)**	**230,308**	**1,171,475**
$ 987,680	**$ 175,936**	**$ 1,039,330**	**$ 447,248**	**$ 3,790,193**
$ 175,580	$ 24,348	$ 1,682,323	$ 122,531	$ 2,054,557
(23,003)	(4,239)	—	(82)	(45,841)
(127,052)	(25,598)	(1,707,727)	(141,981)	(2,043,552)
25,525	(5,489)	(25,404)	(19,532)	(34,836)
—	—	—	—	1,545
—	—	—	—	(4,762)
12,341	—	(53,199)	8,621	(31,952)
(1,341)	—	—	(493)	(1,834)
(17,117)	—	—	—	(17,117)
—	—	—	52,777	52,777
—	(41,302)	—	(26,848)	(68,716)
19,408	(46,791)	(78,603)	14,525	(104,895)
239,602	**222,653**	**(101,965)**	**215,783**	**1,276,370**
$ 259,010	**$ 175,862**	**$ (180,568)**	**$ 230,308**	**$ 1,171,475**
$ 64,077	$ 15,327	$ 234,740	$ (28,137)	$ 338,065
(32,063)	(41,302)	—	(1,156)	(79,849)
40,301	—	—	6,477	15,203
2,818	—	(141,831)	8,621	(130,107)
75,133	**(25,975)**	**92,909**	**(14,195)**	**143,312**
349,642	**61,178**	**90,306**	**338,713**	**916,364**
$ 424,775	**$ 35,203**	**$ 183,215**	**$ 324,518**	**$ 1,059,676**

NOTE 18. 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, as well as acquisition of equipment. This debt is collateralized solely by the credit of private and public entities and is administered by trustees independent of the State. As of June 30, these component units had $14.8 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 the nonmajor component units mentioned above, 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, but that may prevent the utilities from offering electricity at lower rates in a competitive market. As of June 30, the special purpose trusts had approximately $3.3 billion of debt outstanding. Like the debt of nonmajor component units, the debt of the special purpose trusts is not debt of the State.

In addition, the State has participated in transactions involving debt issued by the Bay Area Toll Authority, which is not part of the State's reporting entity. The debt was issued to finance improvements to existing bridges and to design and construct new bridges. As of June 30, the Bay Area Toll Authority had $400 million of debt outstanding, which is not debt of the State.

NOTE 19. CONTINGENT LIABILITIES

A. Litigation

The primary government is a party to numerous legal proceedings, many of which normally occur in governmental operation. 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, 2002; legal proceedings that were in progress as of June 30, 2002, and were settled or decided against the primary government as of January 24, 2003; and legal proceedings having a high probability of resulting in a decision against the primary government as of January 24, 2003, 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 involved.

In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may require it to make significant future expenditures or may impair future revenue sources. 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 reached a settlement agreement for a lawsuit, *United States, People of the State of California v. J.B. Stringfellow, Jr., et al.*, related to recovery for past cleanup costs of the Stringfellow toxic waste site, declarations that the defendants are jointly and severally liable for future costs, and an injunction ordering completion of the cleanup. The defendants filed a counterclaim against the primary government for alleged negligent acts. Under the terms of the agreement, the State agreed to waive recovery of approximately $90 million that it expended at the site. In return, the defendants agreed to waive recovery from the State of approximately $93 million that they expended for cleanup work and to pay the primary government an additional $6.5 million. The primary government also agreed to pay for future cleanup actions at the Stringfellow site.

The primary government is a defendant in two actions, *Cigarettes Cheaper!, et al., v. Board of Equalization, et al.*, and *California Assn. of Retail Tobacconists, et al. v. Board of Equalization, et al.*, that challenge the constitutionality of Proposition 10. The plaintiffs allege that Proposition 10, which increases the excise tax on tobacco products, violates 11 sections of the California Constitution and related provisions of law. The primary government filed notices of related cases. If the statute ultimately is declared unconstitutional, exposure may include the entire $750 million that is collected annually, together with interest on these collections. On November 15, 2000, the trial court ruled completely in the primary government's favor. Judgment was entered on January 9, 2001, and both plaintiff groups filed notices of appeal on time. There was a third plaintiff originally involved in this action; however, McLane/Suneast, Inc., has since dismissed its appeal. As of September 24, 2002, the case was fully briefed by the parties and they are waiting for the court to set the case for oral argument.

The primary government is a defendant in an action, *Ronald Arnett, et al., v. California Public Employees' Retirement System (PERS); California Board of Administration of PERS; et al.*, that challenges Section 21417 of the Government Code pertaining to industrial disability retirement benefits. The plaintiffs allege that Section 21417 makes retirement decisions based upon age, in

violation of the Age Discrimination in Employment Act of 1967. In June 2001, the parties entered into a partial settlement of this action that was accepted by the Federal District Court. The primary government agreed to uncap future industrial disability retirement benefits to affected state employees. The parties also agreed that the district court would form a class of local public entity employers to resolve issues regarding the rights of PERS under state law with regard to those public entity employers. This was accomplished by May of 2002. Thereafter, at the direction of the court, PERS and the attorneys representing the defendant class filed with the court their respective motions for summary judgment with respect to state law issues. These motions were decided by the court in August 2002. Then, there was a court-ordered settlement conference in November 2002. As a result, a further tentative settlement agreement was reached. The essential terms and provisions of the tentative settlement agreement are pending approval. Since liability cannot be predicted, an estimate of any resulting damages is not possible.

The primary government is party to several lawsuits and regulatory proceedings related to the Department of Water Resources (DWR) entering into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency. Legislation established the Department of Water Resources Electric Power Fund (Power Fund) on January 19, 2001, and subsequent legislation expanded the powers of the fund to incur debt for the purposes of the fund and to use amounts in the fund for the purchase of power. As authorized by this legislation, DWR began selling electricity to end-use customers of three companies, collectively referred to as the investor-owned utilities (IOUs) in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and in short-term and spot market transactions. DWR electricity is delivered to end-use customers through the transmission and distribution systems of the IOUs, and payments from the end-use customers are collected for DWR by the IOUs pursuant to service agreements approved and/or ordered by the California Public Utilities Commission (CPUC). Legislation authorizes DWR and the CPUC to enter into an agreement with respect to charges for the purposes of the legislation to provide for recovery by DWR of its revenue requirements. DWR financed its power purchases with advances from the primary government's General Fund, loans from financial institutions, and revenues from power sales to customers. DWR is authorized to issue bonds in an amount not to exceed $13.4 billion and payable solely from the Power Fund and to deposit the proceeds of the bonds in the Power Fund for use for any of the Power Fund's purposes.

The lawsuits and regulatory proceedings include, among others, an IOU contesting DWR's determination that its revenue requirement submissions to the CPUC for calendar year 2001 and 2002 are just and reasonable. The Court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The Court also ruled that its decision did not affect any action taken by the CPUC, including the implementation of cost recovery of DWR's calendar years 2001 and 2002 revenue requirements. DWR has filed its 2003 and amended 2001-2002 revenue requirements with the CPUC. On October 21, 2002, the IOU filed a lawsuit on the 2003 revenue requirements, claiming that DWR had not adequately followed APA requirements.

In another matter, two energy suppliers have petitioned the Federal Energy Regulatory Commission (FERC), contending that amounts totaling $58 million are owed by DWR for the power purchased in the last half of January 2001 by DWR on behalf of two IOUs in the California Independent System Operator (ISO) market. DWR maintains that the Power Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. The ISO distributed the Power Fund's January payment on a pro-rata basis to all market participants for the entire month, although DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the amounts owed them for power purchased in January by DWR on behalf of the two IOUs. FERC has not announced when it will rule on this matter or whether it will require DWR to make additional payments to the ISO.

Various actions are underway contesting certain long-term power contracts entered into by DWR. In addition, other lawsuits and regulatory proceedings in which the primary government is a party may affect the price or supply of energy in California. In one case, the California Power Exchange Corporation (CalPX), certain IOUs, and others have brought suit against the State of California, claiming that the State's assumption of CalPX's block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of $1.1 billion, which is their estimation of the fair value of the block forward contracts at the time the State assumed them. Under the block forward contracts, which expired in December 2001, the Power Fund paid approximately $350 million for energy provided by the contracts. These lawsuits and regulatory proceedings could impact the revenue requirements and rate structure needed to repay debt, and the terms and conditions of the power purchase contracts. Because the legal and regulatory proceedings are in an early stage, the ultimate outcome of these matters cannot presently be determined.

The primary government is a defendant in three actions, *Fong v. Connell*, *Taylor v. Connell*, and *Harris v. Connell*. In all three actions, plaintiffs claim that the State Controller's Office (SCO) has a constitutional and statutory duty to give notice prior to the time that the SCO sells property that has escheated to the State. Because plaintiffs allegedly were not given notice prior to the SCO's sale of their shares of stock, plaintiffs seek to recover either the current value of the stock or its value when they made their claim for its return, whichever is higher. Plaintiffs also seek to have these cases converted into class actions. Judgment in favor of the primary government has been entered in all three cases. All plaintiffs have appealed the judgments. An unfavorable outcome to the primary government is reasonably possible. Plaintiffs' individual damages are approximately $2 million but, if they are successful in converting these cases into class actions and if they ultimately prevail on merits, damages would total in excess of $1.5 billion.

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

B. Federal Audit Exceptions

The primary government receives substantial funding from the federal government in the form of grants and other federal assistance. The primary government and the University of California 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 and the University of California may incur a liability to the federal government.

NOTE 20. PENSION TRUSTS

Two retirement systems, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), are included in the primary government. One retirement system, the University of California Retirement System (UCRS), is included in the discretely presented component units. 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 Tables 22 and 23 as the net pension obligation (NPO) as of

June 30, 2002. Information on the investments of the retirement systems is included 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 Replacement Benefit Fund (RBF), and the 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, Central Supply, P.O. Box 942715, Sacramento, California 94229.

CalPERS uses the accrual basis of accounting. Member contributions are recorded when due, except for the VFF, the SPOFF, and the RBF, which are funded only by employer contributions. Employer contributions 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 two defined benefit retirement plans within the State Teachers' Retirement Plan: the Defined Benefit Program (DBP) 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 DBP. 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, Audits Division, 7667 Folsom Boulevard, 2nd Floor, Sacramento, California 95826.

CalSTRS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are due. Employer and primary government contributions are recognized when due and the employer or the primary government has made a formal commitment to provide the contributions. Benefits are recognized when due and payable, in accordance with the retirement 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 1,387 public agencies as of June 30, 2002.

The excess of the actuarial value of assets over the actuarial accrued liability of PERF for the primary government and other participating agencies was $17.7 billion at June 30, 2001. This is a result of the difference between the actuarial value of assets of $166.9 billion and the actuarial accrued liability of $149.2 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 miscellaneous, second-tier miscellaneous, industrial, California Highway Patrol, peace officers and firefighters, and other safety members. The payroll for primary government employees covered by the PERF in the year ended June 30, 2002, was approximately $12.2 billion.

All employees 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 plan, 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. With the exception of employees in the second-tier plan, employees' required contributions vary from 5.0% to 9.0% 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, without group term life insurance benefits, are shown in Table 21.

Table 21

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

Year Ended June 30, 2002

	Normal Cost	Unfunded Liability	Group Term Life Benefit	Total Rate
Miscellaneous members				
First tier	10.246 %	(6.116) %	0.036 %	4.166 %
Second tier	6.099	(6.099)	0.036	0.036
Industrial	10.239	(9.957)	0.068	0.350
California Highway Patrol	16.897	0.000	0.000	16.897
Peace officers and firefighters	16.052	(6.434)	0.020	9.638
Other safety members	14.683	(1.825)	0.065	12.923

For the year ended June 30, 2002, the annual pension cost (APC) and the amount of contributions made by the primary government were each $700 million. The APC and the percentage of APC contributed for the last three years are shown in Table 22. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 2001, is also shown in Table 22.

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, municipal courts, and justice courts appointed or elected prior to November 9, 1994. There are 59 employers participating in the JRF for the year ended June 30, 2002. The payroll for employees covered by the JRF for the year ended June 30, 2002, was approximately $151 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, 2002, 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, 2002, 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 contributions made to the JRF for the year ended June 30, 2002, were $161 million and $65 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 2002, was $899 million, an increase of $96 million over last year's balance of $803 million. The APC is comprised of $164 million for the annual required contribution (ARC), $60 million for interest on the NPO, and $63 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 22. Information on the last valuation, which was performed as of June 30, 2001, is also shown in Table 22. The aggregate cost method that was used for the June 30, 2001, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 22.

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, 2002, was approximately $67 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, 2002, the required member rate for the JRF II was 8.0%. For the year ended June 30, 2002, the primary government's contribution rate for the JRF II was 18.51% 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, 2002, the annual pension cost (APC) and the amount of contributions made for the JRF II were approximately $11.1 million and $12.5 million, respectively. The APC and the percentage of APC contributed for the year ended June 30, 2002, are shown in Table 22. Information on the last valuation, which was performed as of June 30, 2001, is also shown in Table 22.

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 in 2002 was approximately $3.3 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, 2002, the actual contributions made by employees were approximately 0.4% of covered payroll. For the year ended June 30, 2002, there was no statutory employer contribution required for the primary government based on the June 30, 2000, valuation, and the primary government did not contribute.

The net pension obligation (NPO) of the LRF on June 30, 2002, was approximately $10.2 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 22. 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, 2001, is also shown in Table 22. The aggregate cost method that was used for the June 30, 2001, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 22.

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 57 fire departments participating in the VFF for the year ended June 30, 2002.

The excess of the actuarial value of assets over the actuarial accrued liability of VFF was approximately $0.3 million at June 30, 2001. This is a result of the difference between the actuarial value of assets of $2.5 million and the actuarial accrued liability of $2.2 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 PERF to correctional officers employed by the State of California.

Funding Policy: Contributions to the plan are funded entirely by the primary government with a contribution rate of 2% of the employee's base pay, not to exceed contribution limits established by the Internal Revenue Code. Contribution requirements are established and may be amended through a memorandum of understanding from the State of California Department of Personnel Administration. These contributions, as well as the participant's share of the net earnings of the fund, are credited to the participant's account. For the year ended June 30, 2002, contributions by the primary government to the SPOFF were approximately $34 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, 2002, there were approximately 32,900 participants.

G. State Teachers' Retirement Fund

Plan Description: CalSTRS administers the State Teachers' Retirement Fund (STRF), which includes the State Teachers' Retirement Plan (STRP). The STRP is comprised of three programs, the Defined Benefit Program (DB Program), the Defined Benefit Supplement Program (DBS Program), and the Cash Balance Benefit Program (CBB Program). These programs are cost-sharing, multiple-employer, defined benefit retirement plans that provide 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, 2002, the DB Program had approximately 1,200 contributing employers. At June 30, 2002, there were approximately 516,000 plan members and 171,000 benefit recipients. The primary government is a non-employer contributor to the DB Program. The payroll for employees covered by the DB Program in 2002 was approximately $22.2 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. DBS Program net assets of $660 million are combined with the assets of the DB Program in the STRF.

The CBB 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 CBB Program is optional to employers. However, if the employer elects to offer the CBB Program, each eligible employee is automatically covered unless the employee elects, within 60 days of hire or the election period determined by the employer, to participate in the DB Program or an alternative plan provided by the

employer. At June 30, 2002, the CBB Program had 25 contributing school districts and approximately 15,000 contributing participants. Assets of the CBB Program of $22 million are combined with the assets of the DB Program in the STRF.

Funding Policy: DB Program benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Member and employer contributions are a percentage of applicable member earnings. The Teachers' Retirement Law governs member and 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. The employer contribution rate is 8.25% of creditable compensation. Under California Education Code Section 22955, the General Fund contribution in 2001-02 and 2002-03 is 1.975% of the creditable compensation of the immediately preceding calendar year upon which members' contributions are based. Beginning in 2003-04, the General Fund contribution will be 2.017% of total creditable compensation from the fiscal year ending in the prior calendar year (i.e., the creditable compensation in 2001-02 for the 2003-04 fiscal year). This is to finance the 1998 legislated benefit increases payable under the DB Program. Up to an additional 1.505% of calendar year payroll is transferred to the DB Program to amortize the unfunded actuarial obligation and to eliminate any normal cost deficit attributable to benefits in effect as of July 1, 1990. The normal cost deficit is the difference between the normal cost rate and member and employer contributions, which equal 14.25% of creditable compensation. Based on the most recent actuarial valuation, as of June 30, 2001, there is no normal cost deficit for benefits in effect as of July 1, 1990.

The DBS Program contribution rate of members is 2% of creditable compensation. There is currently no employer or primary government contribution to the program.

For the year ended June 30, 2002, the annual pension cost (APC) for the DB Program was approximately $2.5 billion, and the employer and primary government contributions were approximately $1.9 billion and $0.4 billion, respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 22. Actuarial valuations of the DB Program are performed biennially. Information from the last valuation is also shown in Table 22.

Table 22

Actuarial Information – Pension Trusts – Primary Government
June 30, 2002

	Public Employees' Retirement	Judges' Retirement	Judges' Retirement II	Legislators' Retirement	State Teachers' Retirement Defined Benefit Program
Last actuarial valuation	June 30, 2001	June 30, 2001	June 30, 2001	June 30, 2001	June 30, 2001
Actuarial cost method	Individual Entry Age Normal	Aggregate Cost	Aggregate Entry Age Normal	Aggregate Cost	Entry Age Normal
Amortization method	Level % of Payroll, Closed	None	Level % of Payroll, Closed	None	Level % of Payroll, Open
Remaining amortization period	6 to 20 years	None	Average of 13 Years	None	29 Years
Asset valuation method	Smoothed Market Value	Market Value	Smoothed Market Value	Smoothed Market Value	Expected Value, 33.33% Adjustment to Market Value
Actuarial assumption					
Investment rate of return	8.25 %	7.50 %	7.75 %	7.50 %	8.00 %
Projected salary increase	4.27-11.33	3.75	3.75	3.75	4.25
Includes inflation at	3.50	3.50	3.50	3.50	3.50
Post-retirement benefit increases	2 to 5	3.75	3.00	3.50	2.00
Annual pension costs (in millions)					
Year ended 6/30/00	$ 171	$ 136	$ 7.5	$ —	$ 1,150
Year ended 6/30/01	163	159	9.6	—	2,035
Year ended 6/30/02	700	164	11.1	—	2,498
Percent contribution					
Year ended 6/30/00	100 %	54 %	100 %	— %	183 %
Year ended 6/30/01	106	57	102	—	115
Year ended 6/30/02	100	40	112	—	90
Net pension obligation (in millions)					
Year ended 6/30/00	$ —	$ 735.2	$ —	$ 10.3	$ —
Year ended 6/30/01	—	803.0	—	10.6	—
Year ended 6/30/02	—	899.0	—	10.2	—
Funding as of last valuation (in millions)					
Actuarial value – assets	$ 66,976	N/A	$ 56.0	N/A	$ 107,654
Actuarial accrued liabilities (AAL) – entry age	64,567	N/A	60.9	N/A	109,881
Excess of actuarial value of assets over AAL (EAV) or (unfunded actuarial accrued liability) (UAAL)	2,409	N/A	(4.9)	N/A	(2,227)
Covered payroll	11,905	N/A	61.5	N/A	20,585
Funded ratio	103.7 %	N/A	91.8 %	N/A	98.0 %
EAV (UAAL) as percent of covered payroll	20.2 %	N/A	(8.1) %	N/A	(10.8) %

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 limit on the maximum amount that can be contributed annually. At June 30, 2002, the VIP had approximately 461 participating employers (school districts) and 2,981 plan members.

I. Teachers' Health Benefits Fund

Plan Description: The Teachers' Health Benefits Fund (THBF) 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, 2002, there were approximately 5,200 benefit recipients.

Funding Policy: The THBF is funded by that portion of the monthly DB Program statutory employer contribution that exceeds the DB Program annual required contribution.

J. Teachers' Replacement Benefit Program Fund

Plan Description: CalSTRS administers the Teachers' Replacement Benefit Program Fund, which provides benefits that exceed the Internal Revenue Code Section 415 (b) limits. The benefits of the program are not vested.

Funding Policy: The program is funded as needed by contributions from employers.

K. University of California Retirement System – Discretely Presented Component Unit Fiduciary Activity

The University of California Retirement System (UCRS) is a fiduciary activity of the Universiy of California, a discretely presented component unit. The UCRS consists of: the University of California Retirement Plan (UCRP), a single-employer defined benefit plan funded with university and employee contributions; the Public Employees' Retirement System Voluntary Early Retirement Incentive Program (PERS-VERIP), a defined benefit plan for university employees who elected early retirement under the plan; and two defined contribution plans with several investment portfolios funded with employee non-elective and elective contributions. Most university career employees participate in UCRS.

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

of the pension benefit is determined by salary rate, age, and years of service credit, with certain cost-of-living adjustments.

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

At June 30, 2002, plan membership totaled 173,343, comprised of 117,776 active members, 19,402 inactive members (terminated vested employees entitled to benefits but not yet receiving them), and 36,165 retirees and beneficiaries currently receiving benefits. The active members include 64,031 current employees who are fully vested. The active members also include 53,745 nonvested current employees covered by the plan. A total of 5,796 terminated nonvested employees are not members of the plan but are eligible for a refund.

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

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

Employees may be required to contribute to the UCRP. The rate of employee contributions is established annually as a percentage of covered wages, pursuant to the regents' funding policy, recommended and certified by an enrolled, independent actuary and approved by the regents, the plan's trustee. During the year ended June 30, 2002, employee contributions to the UCRP were redirected to the University of California Defined Contribution Plan.

For the year ended June 30, 2002, there were no employer contributions, annual pension costs, or net pension obligations. The annual pension cost was equal to the actuarially determined contribution.

The actuarial value of assets was determined using techniques that smooth the effect of short-term volatility in the fair value of

investments over a five-year period. The actuarial value of assets in excess of the actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at June 30, 2002, was 13.1 years.

In November 2001, the regents approved a capital accumulation provision accrual credit, effective April 1, 2002. Each active member will receive a credit equal to 3% of eligible covered compensation earned between April 1, 2001, and March 31, 2002, plus annual interest at the assumed earnings rate of the UCRP. This plan amendment increased the actuarial accrued liability by approximately $195 million for the year ended June 30, 2002.

In January 2001, the regents approved changes to the benefit provisions that became effective January 1, 2001. These changes increased the actuarial accrued liability by approximately $800 million for the year ended June 30, 2001.

There were no changes in actuarial assumptions or benefit provisions that significantly affected the actuarial accrued liability or contribution requirements for the year ended June 30, 2000.

The PERS-VERIP is a defined benefit pension plan providing lifetime supplemental retirement income and survivor benefits to members of the University of California CalPERS program (UC-PERS) who elected early retirement under provisions of the plan. The university contributed to the CalPERS program on behalf of these UC-PERS members. Of 1,579 eligible employees, 879 elected to retire under this voluntary early-retirement program. The cost of contributions made to the plan is borne entirely by the university and the federal Department of Energy laboratories. Over the five-year period ended June 30, 1996, the university and the Department of Energy laboratories were required to make contributions to the plan sufficient to maintain the promised benefits and the qualified status of the plan, as determined by the plan's consulting actuary.

The University of California maintains two defined contribution plans that provide savings incentives and additional retirement security for all eligible university employees. The Defined Contribution Plan (DC Plan) accepts both after-tax and pretax contributions. Effective July 1, 2001, the regents adopted a provision for matching employer and employee contributions to the DC Plan related to certain summer session teaching or research compensation for eligible academic employees. Employer contributions to the DC Plan were $3.4 million for the year ended June 30, 2002. In addition, the university has established a Tax Deferred 403(b) Plan. There are no employer contributions to the 403(b) Plan. Participants in the DC Plan and the 403(b) Plan may direct their elective and nonelective contributions to investment

funds managed by the treasurer of the regents of the university. Participants may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis. The participants' interest in external mutual funds is shown separately on the statement of plans' fiduciary net assets.

The DC Plan pretax contributions are fully vested and are mandatory for all employees who are members of the University of California Retirement Plan. Monthly employee contributions range from approximately 2% to 4% of covered wages, depending upon whether wages are above or below the Social Security wage base. The 403(b) Plan and the DC Plan after-tax options are generally available to all university employees.

Additional information on the retirement plans can be obtained from the 2001-2002 annual reports of the University of California Retirement Plan, the PERS-VERIP, the DC Plan, and the 403(b) Plan.

The annual required contribution for the current year was determined as part of the June 30, 2002, actuarial valuation, which is the latest available information, using the entry age normal actuarial cost method. Significant actuarial assumptions used in the valuation are shown in Table 23. Information from the last valuation is also shown in Table 23.

Table 23

Actuarial Information – University of California – Discretely Presented Component Unit

June 30, 2002

	University of California Retirement Plan	Voluntary Early Retirement Incentive Plan
Last actuarial valuation	June 30, 2002	June 30, 2002
Actuarial cost method	Entry Age Normal	Unit Credit
Amortization method	Level % of Payroll, Open	N/A
Remaining amortization period	13.1 years	N/A
Asset valuation method	Smoothed Fair Value	Fair Value
Actuarial assumption		
Investment rate of return	7.5 %	7.5 %
Projected salary increase	4.5 to 6.5	N/A
Includes inflation at	4	4
Annual pension costs (in millions)		
Year ended 6/30/00	$ —	$ —
Year ended 6/30/01	—	—
Year ended 6/30/02	—	—
Percent contribution		
Year ended 6/30/00	N/A	N/A
Year ended 6/30/01	N/A	N/A
Year ended 6/30/02	N/A	N/A
Net pension obligation (in millions)		
Year ended 6/30/00	$ —	$ —
Year ended 6/30/01	—	—
Year ended 6/30/02	—	—
Funding as of last valuation (in millions)		
Actuarial value – assets	$ 41,649	$ 72.8
Actuarial accrued liabilities (AAL)	30,100	51.0
Excess of actuarial value of assets over AAL (EAV)	11,549	21.7
Covered payroll	7,227	N/A
Funded ratio	138.4 %	142.6 %
EAV as percent of covered payroll	159.8 %	N/A

NOTE 21. POST-RETIREMENT HEALTH CARE BENEFITS

Health care and dental benefits are provided by the primary government and certain discretely presented component units, to annuitants of retirement systems to which the primary government contributes as an employer. The discretely presented component units' participation in these plans is not a material portion of the program. To be eligible for these benefits, first-tier plan annuitants must retire on or after age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within 120 days of separation from employment to be eligible to receive these benefits. As of June 30, approximately 114,200 annuitants were enrolled to receive health benefits and approximately 92,800 annuitants were enrolled to receive dental benefits. In accordance with the 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 primary government generally pays 100% of the dental insurance premium for annuitants, the Government Code does not specify the primary government's contribution toward dental insurance costs. 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 was approximately $458 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 36,600 retirees currently 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, 2002, was $129.5 million.

NOTE 22. SUBSEQUENT EVENTS

The following information describes significant events that occurred subsequent to June 30, 2002, but prior to the date of the auditor's report.

The primary government issued $800 million in general obligation bonds to retire previously issued commercial paper, to repay internal state loans, and to finance various school, wildlife, coastal,

and park projects. The primary government also issued revenue anticipation notes of $12.5 billion that are due to be redeemed on June 20 and 27, 2003, in the amounts of $9.5 billion and $3.0 billion, respectively. In addition, $7.5 billion of revenue anticipation warrants issued on June 24, 2002, matured or were redeemed on October 25 and November 27, 2002, in the amounts of $1.5 billion and $6.0 billion, respectively.

The Department of Water Resources issued $11.3 billion of Power Supply Revenue Bonds to repay loans from certain external parties and loans from the General Fund. The department also issued approximately $609 million of Central Valley Project Water System Revenue Bonds.

California State University issued approximately $343 million in revenue bonds.

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, issued lease revenue bonds totaling $578 million.

The Golden State Tobacco Securitization Corporation sold $3.0 billion in Tobacco Settlement Asset – Backed Bonds.

The regents of the University of California issued approximately $366 million in revenue bonds.

The California Housing Finance Agency, a discretely presented component unit, issued approximately $317 million in revenue bonds. The California Infrastructure and Economic Development Bank, another discretely presented component unit, issued $300 million in revenue bonds.

In the general election held on November 5, 2002, voters approved the sale of $18.6 billion in general obligation bonds with the passage of three propositions: $2.1 billion for Proposition 46, the Housing and Emergency Shelter Trust Fund Act of 2002; $13.1 billion for Proposition 47, the Kindergarten-University Public Education Facilities Bond Act of 2002; and $3.4 billion for Proposition 50, the Water Quality, Supply and Safe Drinking Water Projects, Coastal Wetlands Purchase and Protection, Bonds Initiative Statute.

In December 2002, Standard and Poor's lowered its rating on California's general obligation bonds from “A+” to “A” and on State Public Works Board lease revenue bonds from “A” to “A-.”

Also in December 2002, Fitch Ratings lowered its rating on California’s general obligation bonds from “AA” to “A” and on State Public Works Board lease revenue bonds from “A+” to “ A-.”

Required Supplementary Information

Schedule of Funding Progress [1]

Public Employees' Retirement Fund

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of the Actuarial Value of Assets over AAL (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll ((a - b) / c)
June 30, 1999	$ 61,233	$ 49,090	$ 12,143	124.7 %	$ 10,778	112.7 %
June 30, 2000	65,948	59,685	6,263	110.5	11,191	56.0
June 30, 2001	66,976	64,567	2,409	103.7	11,905	20.2

Judges' Retirement Fund II

(amounts in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of the Actuarial Value of Assets over AAL or (Unfunded Actuarial Accrued Liability) (UAAL) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll or (UAAL as a Percent of Covered Payroll) ((a - b) / c)
June 30, 1999	$ 27,155	$ 26,921	$ 234	100.9 %	$ 39,959	0.6 %
June 30, 2000	40,503	41,619	(1,116)	97.3	42,983	(2.6)
June 30, 2001	55,955	60,933	(4,979)	91.8	61,547	(8.1)

State Teachers' Retirement Defined Benefit Program

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of the Actuarial Value of Assets over AAL or (Unfunded Actuarial Accrued Liability) (UAAL) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll or (UAAL as a Percent of Covered Payroll) ((a - b) / c)
June 30, 1999	$ 90,001	$ 86,349	$ 3,652	104.2 %	$ 17,185	21.3 %
June 30, 2000	102,225	93,124	9,101	109.8	18,224	49.9
June 30, 2001	107,654	109,881	(2,227)	98.0	20,585	(10.8)

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

University of California Retirement System

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of the Actuarial Value of Assets over AAL (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2000	$ 37,026	$ 24,067	$ 12,959	153.8 %	$ 5,903	219.5 %
June 30, 2001	40,554	27,451	13,103	147.7	6,539	200.4
June 30, 2002	41,649	30,100	11,549	138.4	7,227	159.8

Infrastructure Assets Using the Modified Approach

To comply with the prospective reporting requirements, all current year additions to the State Highway System (completed projects and purchased land) and construction work-in-progress (uncompleted projects) are being reported. The estimated budgeted preservation costs, actual preservation costs, established condition levels, and actual condition levels are not being reported because the reported infrastructure asset value is not material.

All costs incurred that are related to State Highway System projects completed prior to the year ending June 30, 2002, will be included during the retroactive reporting phase. Retroactive reporting of the State Highway System general infrastructure assets in the financial statements will occur not later than the year ending June 30, 2006. When the value of the reported infrastructure assets becomes material, the estimated budgeted preservation costs, actual preservation costs, established condition levels, and actual condition levels of the State Highway System will be included.

Budgetary Comparison Schedule

General Fund and Major Special Revenue Funds

Year Ended June 30, 2002
(amounts in thousands)

	General Fund			
	Budgeted Amounts		Actual	Variance with
	Original	Final	Amounts	Final Budget
REVENUES				
Corporation tax	—	—	$ 5,333,025	—
Intergovernmental	—	—	—	—
Cigarette and tobacco taxes	—	—	121,611	—
Inheritance, estate and gift taxes	—	—	890,627	—
Insurance gross premiums tax	—	—	1,595,846	—
Vehicle license fees	—	—	15,372	—
Motor vehicle fuel tax	—	—	—	—
Personal income tax	—	—	33,046,664	—
Retail sales and use taxes	—	—	21,355,315	—
Other major taxes and licenses	—	—	295,923	—
Other revenues	—	—	1,405,926	—
Total revenues	**—**	**—**	**64,060,309**	**—**
EXPENDITURES				
State and consumer services	$ 591,400	$ 644,145	628,230	$ 15,915
Business and transportation	186,495	176,883	167,414	9,469
Resources	1,568,085	1,565,950	1,433,598	132,352
Health and human services	22,479,931	22,608,520	21,820,039	788,481
Correctional programs	5,096,653	5,261,393	5,223,912	37,481
Education	39,875,180	39,103,742	37,187,246	1,916,496
General government:				
Tax relief	3,438,444	3,438,444	3,381,810	56,634
Debt service	2,484,745	2,484,745	2,432,604	52,141
Other general government	4,302,647	4,430,321	4,276,331	153,990
Total expenditures	**$ 80,023,580**	**$ 79,714,143**	**76,551,184**	**$ 3,162,959**
OTHER FINANCING SOURCES (USES)				
Transfers from other funds	—	—	2,143,250	—
Transfers to other funds	—	—	(301,158)	—
Other additions and deductions	—	—	33,932	—
Total other financing sources (uses)	**—**	**—**	**1,876,024**	**—**
Excess of revenues and other sources over expenditures and other uses	—	—	(10,614,851)	—
Fund balances, July 1, 2001	**—**	**—**	**8,505,091** *	**—**
Fund balances (deficits), June 30, 2002	**—**	**—**	**$ (2,109,760)**	**—**

* Restated

Federal				Transportation Construction			
Budgeted Amounts		Actual	Variance with	Budgeted Amounts		Actual	Variance with
Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget
—	—	$ —	—	—	—	$ —	—
—	—	33,429,736	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	689,400	—
—	—	—	—	—	—	3,295,903	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	1,272	—	—	—	257,362	—
—	**—**	**33,431,008**	**—**	**—**	**—**	**4,242,665**	**—**
$ 5,350	$ 5,350	5,350	—	$ 1	$ 1	—	$ 1
2,798,132	2,798,132	2,798,132	—	4,174,223	4,227,995	3,645,043	582,952
256,502	256,502	256,502	—	12	12	12	—
22,950,083	22,950,083	22,950,083	—	—	—	—	—
378,733	378,733	378,733	—	—	—	—	—
5,021,597	5,021,597	5,021,597	—	956	956	956	—
—	—	—	—	1,282,286	1,282,286	1,282,286	—
—	—	—	—	500	500	338	162
997,653	997,653	997,653	—	(113,307)	(112,845)	(112,895)	50
$ 32,408,050	**$ 32,408,050**	**32,408,050**	**—**	**$ 5,344,671**	**$ 5,398,905**	**4,815,740**	**$ 583,165**
—	—	5,452,610	—	—	—	5,557,264	—
—	—	(6,491,560)	—	—	—	(5,605,743)	—
—	—	—	—	—	—	5,086	—
—	**—**	**(1,038,950)**	**—**	**—**	**—**	**(43,393)**	**—**
—	—	(15,992)	—	—	—	(616,468)	—
—	**—**	**25,132**	**—**	**—**	**—**	**3,069,895** *	**—**
—	**—**	**$ 9,140**	**—**	**—**	**—**	**$ 2,453,427**	**—**

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

June 30, 2002
(amounts in thousands)

		Special Revenue Fund Types	
	General	Federal	Transportation Construction
Budgetary fund balance reclassified into GAAP statement fund structure	**$ (2,109,760)**	**$ 9,140**	**$ 2,453,427**
Basis difference:			
Interfund receivables	76,991	—	180,000
Loans receivable	110,446	42,743	—
Interfund payables	(238,000)	—	—
Escheat property	(707,805)	—	—
Authorized and unissued bonds	—	—	(11,130)
Other	(116,916)	—	(1,393)
Timing difference:			
Liabilities budgeted in subsequent years	(536,538)	(7,911)	(72,770)
GAAP fund equity, June 30, 2002	**$ (3,521,582)**	**$ 43,972**	**$ 2,548,134**

Notes to the Required Supplementary Information

Budgetary Comparison Schedule

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

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

general government can result when current encumbrances are significantly higher than prior year encumbrances.

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 2400.112. 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 a minor program of the Highway Construction Fund are not included in the Annual Report Supplement statements, because they are considered fiduciary fund activities on the budgetary basis. A copy of this report is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

Reconciliation of Budgetary Basis with GAAP Basis

The Reconciliation of Budgetary Basis Fund Balances of the General Fund and the Major Special Revenue Funds and GAAP Basis Fund Balances is presented on the previous page and is explained in the following paragraphs.

The beginning fund balances for the General Fund and the 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 prior year accrual of revenues. 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 this adjustment.

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 an increase to the fund equity of $77 million in the General Fund and an increase to the fund equity of $180 million in the Transportation Construction Fund. The adjustments related to loans receivable caused an increase of

$110 million in the General Fund and $43 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 decrease to fund equity of $238 million in the General Fund.

Escheat Property: A liability for the estimated amount of escheat property ultimately expected to be reclaimed and paid is not reported on a budgetary basis, while it is required to be reported in the interfund payables on a GAAP basis. This adjustment caused a $708 million decrease to the General Fund balance.

Authorized and Unissued Bonds: General obligation bonds that are not self-liquidating are recorded as additions to the fund balance for the special revenue and capital projects funds on the budgetary basis when voters authorize the sale of bonds. However, in accordance with GAAP, only the bonds issued during the year are recorded as additions to the fund balance. The adjustments related to authorized and unissued bonds caused a decrease to the fund balance of $11 million in the Transportation Construction Fund.

Other: Certain other adjustments and reclassifications are necessary to present the financial statements in accordance with GAAP. The other adjustments caused decreases to the fund equity of $117 million in the General Fund and $1 million in the Transportation Construction Fund.

Timing Difference

Liabilities Budgeted in Subsequent Years: The primary government does not, on a budgetary basis, 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 a net decrease to the fund balance of $537 million in the General Fund, $8 million in the Federal Fund, and $73 million in the Transportation Construction Fund.

Part Two

State of California: Internal Control and State and Federal Compliance Audit Report for the Year Ended June 30, 2002

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AUDITOR’S SECTION

Independent Auditor's Reports on Compliance and Internal Control

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting 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 State of California as of and for the year ended June 30, 2002, and have issued our report thereon dated January 24, 2003. 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 71 percent of the assets and 56 percent of the revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 99 percent of the assets and 99 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- Certain funds that represent 99 percent of the assets and 98 percent of the revenues of the Housing Loan fund, a major enterprise fund.
- 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 42 percent of the assets and 81 percent of the revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 90 percent of the assets of the fiduciary funds.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for those funds and entities, is based solely 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.

COMPLIANCE

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

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the State of California's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State of California's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2002-19-1 through 2002-19-6.

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

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

January 24, 2003

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

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

The Governor and the Legislature of
the State of California

COMPLIANCE

We have audited the compliance of the State of California with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2002. 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 Drinking Water State Revolving Fund (CFDA Number 66.468). This program, which accounts for less than one percent of the total of 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, 2002. The University of California and the California State University systems, and the California Housing Finance Agency, which reported expenditures of federal awards totaling $2.4 billion and $1 billion, and $68.9 million, respectively, engaged other auditors to perform an audit in accordance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133).

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133. Those standards and OMB Circular A-133

require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the State of California's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report 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.

As described in item 2002-13-6 in the accompanying schedule of findings and questioned costs, the State of California did not comply with requirements regarding subrecipient monitoring that are applicable to its Community Development Block Grant/State's Program (CFDA Number 14.228). Compliance with such requirements is necessary, in our opinion, for the State of California to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, the State of California did not comply in all material respects, with the requirements referred to above that are applicable to the Community Development Block Grant/State's Program (CFDA Number 14.228). Also, in our opinion, based on our audit and the report of the other auditors, the State of California complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 2002. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs. See the attachment for a list of these issues.

INTERNAL CONTROL OVER COMPLIANCE

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

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

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions listed in the attachment is a material weakness.

SCHEDULE OF FEDERAL ASSISTANCE

We have audited the basic financial statements of the State of California as of and for the year ended June 30, 2002, and have issued our report thereon dated January 24, 2003. 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 71 percent of the assets and 56 percent of the revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 99 percent of the assets and 99 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- Certain funds that represent 99 percent of the assets and 98 percent of the revenues of the Housing Loan fund, a major enterprise fund.
- 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 42 percent of the assets and 81 percent of the revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 90 percent of the assets of the fiduciary funds.
- The discretely presented component units noted above.

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

Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. 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

January 24, 2003

Attachment

ATTACHMENT

The compliance issues are:

2002-1-1
2002-1-2
2002-1-3
2002-2-1
2002-2-2
2002-2-3
2002-2-4
2002-2-5
2002-3-1
2002-3-2
2002-3-3
2002-3-5
2002-3-7
2002-3-8
2002-3-10
2002-3-11
2002-3-12
2002-3-13
2002-3-14
2002-3-15
2002-3-16
2002-5-1
2002-7-1
2002-7-2
2002-8-1
2002-9-1
2002-9-2
2002-12-1
2002-12-4
2002-12-5
2002-12-7
2002-12-8
2002-13-1
2002-13-2
2002-13-3
2002-13-4
2002-13-5
2002-13-6
2002-13-7
2002-13-8
2002-14-2
2002-14-3
2002-14-5

The internal control over compliance issues are:

2002-3-1
2002-3-4
2002-3-6
2002-3-9
2002-3-10
2002-7-2
2002-9-3
2002-9-4
2002-9-5
2002-9-6
2002-9-7
2002-12-2
2002-12-3
2002-12-6
2002-13-3
2002-13-8
2002-14-1
2002-14-4

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Schedule of Findings and Questioned Costs

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

Summary of Auditor's Results

Financial Statements

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

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Type of report the auditor issued on compliance for major programs	Unqualified opinion on all major programs except for Community Development Block Grant/State's Program (CFDA Number 14.228), which was qualified
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	$64.2 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 Nutrition Cluster
	Disability Insurance/SSI Cluster
	Emergency Food Assistance Cluster
	Employment Services Cluster
	Food Stamp Cluster
	Highway Planning and Construction Cluster
	Medicaid Cluster
	Special Education Cluster
	Student Financial Aid Cluster
	Workforce Investment Act Cluster
10.550	Food Distribution
10.557	Special Supplemental Nutrition Program for Women, Infants, and Children
10.558	Child and Adult Care Food Program
14.228	Community Development Block Grant/State's Program
14.239	HOME Investment Partnerships Program
16.606	State Criminal Alien Assistance Program
17.225	Unemployment Insurance
17.253	Welfare-to-Work Grants to States and Localities
17.255	Workforce Investment Act
64.114	Veterans Housing—Guaranteed and Insured Loans
66.458	Capitalization Grants for State Revolving Funds
66.468	Capitalization Grants for Drinking Water State Revolving Fund
83.544	Public Assistance Grants
83.548	Hazard Mitigation Grant
84.010	Title I Grants to Local Educational Agencies
84.011	Migrant Education—Basic State Grant Program
84.048	Vocational Education—Basic Grants to States
84.126	Rehabilitation Services—Vocational Rehabilitation Grants to States
84.298	Innovative Education Program Strategies
84.340	Class Size Reduction
93.268	Immunization Grants
93.558	Temporary Assistance for Needy Families
93.568	Low-Income Home Energy Assistance
93.569	Community Services Block Grant
93.658	Foster Care—Title IV-E
93.659	Adoption Assistance
93.667	Social Services Block Grant
93.917	HIV Care Formula Grants
93.959	Block Grant for Prevention and Treatment of Substance Abuse

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

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SECRETARY OF STATE

Reference Number: 2002-19-1

CONDITION

For the fiscal year ending June 30, 2001, we reported that the Secretary of State's Office did not exercise adequate control over its cash account during fiscal year 1999-2000. Specifically, it did not promptly remit cash receipts to the State Treasurer's Office (Treasurer's Office), prepare required monthly bank reconciliations, or take action to cancel or send stop payment requests to the Treasurer's Office for stale-dated checks that its records indicated were outstanding. In addition, the Secretary of State's Office did not adequately segregate duties in its accounting unit according to the State Administrative Manual (SAM) directions. In its corrective action plan, the Secretary of State's Office stated that it believed that the accounting problems were related to its new accounting system. Further, it stated that it had addressed the conditions described above by improving its reporting system, remitting cash receipts to the Treasurer's Office every other day, and reconciling its bank account monthly. Also, it reported that it was in the process of clearing or canceling stale-dated checks. Finally, it indicated that the accounting unit had reorganized the job duties to ensure that no one person performed more than one of the duties outlined in the SAM.

At the time of our follow-up review in December 2002, we determined that the accounting unit improved its operations by remitting cash to the Treasurer's Office on time, reconciling its bank account monthly from June 2002 through October 2002, and canceling 251 stale-dated checks that had been outstanding at the time of our previous review. However, the accounting unit has not continued to cancel or send stop payment requests to the Treasurer's Office, and still recorded approximately 1,100 checks, totaling $31,000 dated on and after June 1, 2001, and over one year old as of December 19, 2002. After we discussed this problem with the accounting unit, it subsequently canceled all stale-dated checks issued from June 2001 through December 2001.

Furthermore, the Secretary of State's Office continues to lack adequate separation of duties in its accounting unit. Specifically, one employee signed claim schedules, printed and issued checks, and controlled blank check forms. Another employee prepared claim schedules from supporting documentation, printed and issued checks, and controlled blank check forms. Finally, an employee prepared invoices, signed claim schedules, and controlled blank check forms. Lack of adequate segregation of duties may allow errors and irregularities to go undetected.

CRITERIA

Section 8042 of the SAM states that office revolving fund and agency checks issued on or after January 1998 have a one-year period of negotiability. Office revolving fund checks outstanding for more than one year should be canceled and the amount of such checks should either be credited back to the revolving fund or remitted to a separate account in the fund from which they were drawn. Furthermore, Section 8045 requires state agencies to send stop payment requests to the Treasurer's Office one week before the stale date of all uncashed agency checks.

The California Government Code, Section 13401, requires state agencies to effectively maintain internal accounting and administrative controls. Section 13403 indicates that such controls include segregation of duties appropriate for proper safeguarding of state agency assets. Specifically, the SAM, Section 8080.1, provides that the same person will not perform more than one of the following types of duties:

- Initiating disbursement documents (preparing claim schedules from supporting documentation)
- Approving disbursements (signing claim schedules)
- Inputting disbursement information to prepare checks (issuing checks)
- Controlling blank check forms
- Initiating or preparing invoices

In addition, persons comparing checks to supporting documentation should not have access to or control blank check stock.

RECOMMENDATIONS

We recommend that the Secretary of State's Office take the following action:

- Appropriately monitor and cancel all stale-dated checks.
- Appropriately segregate duties in its accounting unit to safeguard assets and ensure accurate record-keeping.

OFFICE'S VIEW AND CORRECTIVE ACTION PLAN

The Secretary of State's Office concurs with our findings and indicates that the accounting unit has established a policy to cancel stale-dated checks on a monthly basis. Further, it stated that due to the hiring freeze and recent elimination of vacant positions, it has been unable to secure additional employees to allow for appropriate segregation of accounting duties. However, it indicates that it is working to ensure the most important duties are appropriately segregated.

VARIOUS STATE DEPARTMENTS

Reference Number: 2002-19-2

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 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 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 less than 24 hours without lodging, and compensation for 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 benefits and taxable business expenses. These employee fringe benefits and business expense reimbursements must then be included in a report 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 departments do not consistently ensure that all employees' taxable benefits or taxable business expense reimbursements are being reported to the Controller's Office. In addition to following up on issues reported for fiscal year 2000-01, we reviewed the reporting of employee taxable benefits and reimbursements at ten state departments for fiscal year 2001-02, including from 73 to 152 travel expense claims at each entity to verify that employee taxable reimbursements were properly reported. However, not all of the travel expense claims we reviewed had taxable fringe benefits claimed.

Of the departments that we reviewed, the Department of Transportation (headquarters and District 3), the Department of Corrections, the California Substance Abuse Treatment Facility—Corcoran, the El Paso de Robles Youth Correctional Facility, and the California School for the Deaf—Riverside did not always ensure that they met the reporting requirements the Controller's Office described. The table on page 23 shows the total number of travel expense claims with reportable items that we reviewed and the number of items the departments did not report to the Controller's Office.

We also determined if those departments that issued vehicle home storage permits reported the personal use of state vehicles to the Controller's Office. Of the departments that we reviewed, the Department of Corrections, the California Substance Abuse Treatment Facility—Corcoran, and the California School for the Deaf—Riverside did not always ensure that they reported the personal use of state vehicles to the Controller's Office. The table also shows the total number of instances of personal use of state vehicles that we reviewed that were not reported to the Controller's Office.

In February 2003, the Department of Corrections informed us that its agents are exempt from reporting personal use of state vehicles based on its view of IRS regulations that exempt unmarked law enforcement vehicles if the employee uses the vehicle for law-enforcement functions. However, to qualify as exempt, specific conditions must be satisfied and documented by actual facts and circumstances. For unmarked law enforcement vehicles to qualify, any personal use must be both authorized and incident to law enforcement functions such as reporting directly from home to a stakeout or surveillance site, or to an emergency situation. In February 2003, we requested the regularly prepared documentation such as comparisons of travel logs and vehicle logs from the managers and supervisors of eight individuals that established that the vehicles met the exemption criteria. The Department of Corrections has a system in place to demonstrate that it met the exemption criteria for the two employees in the transportation unit that we reviewed. However, it does not have support that it met the criteria for six employees in the Office of Investigative Services we reviewed.

Further, the Department of Corrections, the California Substance Abuse Treatment Facility—Corcoran, the El Paso de Robles Youth Correctional Facility, and the California School for the Deaf—Riverside have not developed written procedures to help ensure that they consistently and correctly report taxable fringe benefits.

We reported similar concerns for fiscal year 2000-2001 at five other departments. Three of these departments have established and implemented internal procedures for reporting taxable benefits to the Controller's Office. However, as we reported the last three fiscal years, the State Water Resources Control Board (board) has not implemented any internal procedures for reporting personal use of state vehicles to the Controller's Office. Further, it has not accurately reported taxable benefits to the Controller's Office. Although the Department of Health Services (Health Services) has developed internal procedures for reporting taxable benefits, it has not accurately reported taxable benefits to the Controller's Office. Health Services sometimes identified taxable meal reimbursements on travel expense claims, but it did not always forward the information to the appropriate staff to report the taxable items to the Controller's Office. The total number of travel expense claims with reportable items that we reviewed and the number of items not reported to the Controller's Office for these two departments are shown in the table on the following page.

Table

Reportable Items Reviewed That Were Not Reported to the Controller's Office in Fiscal Year 2001-02

State Agency	Total Number of Travel Expense Claims With Reportable Items Reviewed	Items Not Reported		
		Overtime/ Callback Mileage	Meals for Less Than 24-Hour Travel/Overtime Meals	Personal Use of State Vehicle*
Department of Transportation	44	2	6	0
Department of Corrections	19	1	10	6
California Substance Abuse Treatment Facility—Corcoran	10	3	0	1
El Paso de Robles Youth Correctional Facility	10	N/A	3	0
California School for the Deaf—Riverside	9	N/A	7	1
Department of Health Services	16	0	10	N/A
State Water Resources Control Board	14	2	10	N/A
TOTALS	122	8	46	8

N/A: None included in travel expense claims reviewed or no vehicle home storage permits issued.
Note: Some travel expense claims contained more than one type of reportable item.
*Personal use of state vehicles is reported on documents separate from travel expense claims.

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 170, 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 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 and incident to law-enforcement functions and the actual facts and circumstances are documented.
- Section 130.1.2 states that reimbursements to employees for commuting expenses, such as for expenses from commuting or personal travel between home and office, is considered taxable income. This would include callback and overtime mileage.
- Section 143.3 states that overtime meal compensation is reportable and taxable income.
- Section 145.1.2 states that meal reimbursement for less than 24-hour travel 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

To ensure proper reporting, all state departments should ensure that they have procedures established and implemented to properly report taxable fringe benefits and taxable employee business expense reimbursements.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

The Department of Transportation agrees with the finding. It indicates that department staff have been reminded to follow established reporting procedures and it has added a secondary review to ensure that taxable fringe benefits are reported to the Controller's Office.

The Department of Corrections agrees with the finding. It indicates that it has established written procedures and provided training to ensure that taxable fringe benefits are properly reported to the Controller's Office.

The Substance Abuse Treatment Facility—Corcoran agrees with the finding. It has corrected the errors for call back mileage and reported them to the State Controller's Office. In addition, it indicates that it is developing procedures for the reporting of personal use of state vehicles and has conducted training to ensure future reporting of taxable fringe benefits to the State Controller's Office is completed on time and accurately.

El Paso de Robles Youth Correctional Facility agrees with the finding. It has corrected the errors found during the testing and reported them to the Controller's Office. In addition, it indicates it now has procedures in place for reporting of taxable benefits and has conducted training to ensure future reporting to the Controller's Office is systematic and complete.

The California School for the Deaf—Riverside agrees with the finding. It indicates that it is in the process of correcting the errors found during the testing and reporting them to the Controller's Office. In addition, it indicates that it is currently developing procedures to ensure that taxable amounts for meals and personal use of state vehicles are reported to the Controller's Office.

The Department of Health Services agrees that the items identified in the review were not reported as taxable. It indicates it has corrected these errors, and reported them to the Controller's Office. The Department of Health Services has procedures implemented to properly report fringe benefits and taxable employee business expense reimbursements. Accounting staff will be reminded again of these procedures to ensure future reporting to the Controller's Office.

The State Water Resources Control Board agrees with the finding. It believes that the items not reported to the State Controller's Office in fiscal year 2001-02 were due to inexperienced staff and indicated it has provided additional training in these areas. On the issue of procedures for reporting the personal use of state vehicles, it recently received approval of a freeze exemption to hire an additional accounting officer who will be responsible for reporting taxable fringe benefits. It therefore anticipates that it will have internal procedures in place by October 1, 2003.

DEPARTMENT OF DEVELOPMENTAL SERVICES

Reference Number: 2002-19-3

CONDITION

Annually, state departments must report to both the Department of General Services (General Services) and the State Controller's Office (Controller's Office) information in their real property holdings. For fiscal year 2001-02, the Department of Developmental Services (Developmental Services) reconciled the list of structures and square footage for all developmental centers in the State to the General Services' Real Estate Services Division Statewide Real Property Inventory. However, it has not reconciled the centers' valuation amounts reported to the Controller's Office on the Statement of Changes in General Fixed Assets with the Statewide Real Property Inventory.

For fiscal year 2000-01, we reported this same condition for Developmental Services' Sonoma Developmental Center (center). Developmental Services had reconciled the center's list of structures and improvements, but the valuation amount it reported to General Services was $27 million less than it reported to the Controller's Office. In its corrective action plan, Developmental Services indicated that it would determine the correct balance to be reflected on the center's Statement of Changes in General Fixed Assets it submits to the Controller's Office. Further, Developmental Services indicated that, once this process was complete and appropriate adjustments had been made, it would implement procedures to ensure that the annual Statewide Real Property Inventory prepared by the center would be forwarded to Developmental Services' Developmental Center Division for review and approval of any necessary adjustments. Finally, Developmental Services stated that the procedures implemented at the center would be followed at the other developmental centers in the State for the year ending June 30, 2002.

Unless Developmental Services reports complete and accurate information to the Controller's Office and/or General Services, the State's financial statements will be misstated and the Statewide Real Property Inventory will be incomplete or 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 the department's information in the Statewide Real Property Inventory.

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.

Further, the Department of Finance (Finance) issued directives in August 1999 and July 2000 requiring agencies to evaluate the risk of an incomplete inventory and to reconcile the amounts reported in the Statewide Real Property Inventory with the Statement of Changes in General Fixed Assets. Finance also required agencies to periodically reconcile their real property inventories to ensure the inventories are complete and accurate.

RECOMMENDATION

Developmental Services should annually reconcile amounts it reports in the Statewide Real Property Inventory to its Statement of Changes in General Fixed Assets.

DEPARTMENT'S VIEWS AND CORRECTIVE ACTION PLANS

Developmental Services concurs with our finding. It indicates that it will determine the proper valuation amounts for the buildings at each of the developmental centers in the State. Further, it states that this process will be completed by June 2003 and any necessary adjustments will be submitted to the Controller's Office to be included in the financial statements for fiscal year 2002-03.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2002-19-4

CONDITION

The Department of Parks and Recreation (Parks and Recreation) has inadequate procedures to account for and report its real property. Its acquisition unit reports real property information to the Department of General Services (General Services) for inclusion in the Statewide Real Property Inventory. Its accounting unit reports real property information to the State Controller's Office (Controller's Office) for inclusion in the State's financial statements. However, for fiscal year 2001-02, the two units did not reconcile their data, and they both reported incorrect information. Specifically, we determined the following:

- Through October 2002, Parks and Recreation's acquisition office reported only two of 42 land additions acquired between July 2001 and June 2002 to General Services' Real Estate Services Division. According to the chief of the acquisition office, it does not plan to complete its review process and report the remaining 40 additions, valued at $185.7 million, to the Real Estate Services Division until June 30, 2003. In addition, it did not report $3.4 million in ancillary costs for the assets because the department's accounting unit did not inform the acquisitions unit of the costs.

- Its accounting unit did not report the gift value of land additions totaling approximately $64 million to the Controller's Office for inclusion in the state's financial statements because the acquisition office did not report the gift value of additions to the accounting unit.

Unless Parks and Recreation reports complete and accurate information to the Controller's Office and General Services' Real Estate Services Division, the State's financial statements will be misstated and/or the Statewide Real 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 the department's information in the Statewide Real Property Inventory.

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.

Further, the Department of Finance (Finance) issued directives in August 1999 and July 2000 requiring agencies to evaluate the risk of an incomplete inventory and to reconcile the amounts reported in the Statewide Real Property Inventory with the Statement of Changes in General Fixed Assets. Finance also required agencies to periodically reconcile their real property inventories to ensure the inventories are complete and accurate.

RECOMMENDATIONS

To ensure proper reporting of property additions in the Statewide Real Property Inventory, the acquisition office should submit a record, annually, of each parcel purchased to General Services' Real Estate Services Division.

The acquisition office should report to the accounting unit the gift value of acquisitions at the time the land is purchased and the accounting unit should report ancillary costs to the acquisition office. By sharing the cost information, each office can ensure that General Services and the Controller's Office receive the same information for the Statewide Real Property Inventory and the state's financial statements.

Parks and Recreation should reconcile the amounts reported in the Statewide Real Property Inventory with its Statement of Changes in General Fixed Assets.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Parks and Recreation concurs with our finding and indicates that it will train staff on reporting requirements for General Services' Statewide Real Property Inventory, as well as monitor the reporting of additions for the Statewide Real Property Inventory. In addition, it indicates that it has taken steps necessary to ensure that gift values are reported to the accounting unit and that it includes ancillary costs of purchasing land in its reporting to General Services.

CALIFORNIA STUDENT AID COMMISSION

Reference Number: 2002-19-5

CONDITION

The California Student Aid Commission (Student Aid) has established a nonprofit auxiliary organization to provide operational and administrative services for Student Aid's participation in the Federal Family Education Loans Program (loan program). We found Student Aid's auxiliary organization did not use best business practices when it hired consultants and certified public accountants from the same firm to provide key services.

Based on its work auditing the auxiliary's financial statements for fiscal year 2000-01, the auxiliary's accounting firm recommended in a management letter that the auxiliary continue its efforts to improve its business continuity capabilities. On February 4, 2002, the auxiliary awarded a contract to provide business continuity planning consulting services to the same firm that had identified the need to further improve the business continuity capabilities of the auxiliary organization. Because the auxiliary organization has also hired the same accounting firm to conduct its financial audit for fiscal year 2001-02, there is the possibility that the accounting firm will audit work done by consultants from the same firm.

Furthermore, public entities are precluded from awarding consulting contracts to firms that recommended or identified work in a previous engagement. However, Student Aid has not required its auxiliary organization to follow this practice. Each year Student Aid enters into an operating agreement with its auxiliary organization. However, we found that Student Aid, through its operating agreement, does not provide direction to its auxiliary organization with regard to contracting.

CRITERIA

The California Education Code, Section 69522, authorized Student Aid to establish a nonprofit auxiliary to administer all 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.

The Public Contracting Code, Section 10365.5, states no person, firm, or subsidiary thereof who has been awarded a consulting services contract may submit a bid for, nor be awarded a contract for, the provision of services, procurement of goods or supplies, or any other related action, which is required, suggested, or otherwise deemed appropriate in the end product of the consulting services contract.

RECOMMENDATION

We recommend that Student Aid, through the operating agreement with its auxiliary organization, require that the auxiliary organization use best business practices and follow state contracting laws as applicable, such as not awarding consulting contracts to firms that recommended or identified work in a previous engagement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Student Aid fully expects that the auxiliary organization perform its responsibilities with the highest level of integrity and with a sharp focus on best business practices.

The auxiliary organization took the following steps in entering into its contract for business continuity planning:

- After determining the business need for the services, a competitive bid process was used to evaluate and select the ultimate vendor.
- Seven proposals were received and an internal committee reviewed and rated each proposal.
- The committee conducted interviews with the top two rated firms, PricewaterhouseCoopers (PwC) and SunGard.
- PwC was selected based on its ability to meet the auxiliary organization's timelines and its superior knowledge and industry experience evidenced through the interviews.

The entire review and decision-making process is fully documented and available for the Bureau of State Audits to review. The above process is fully consistent and in accord with the auxiliary organization's internal policy on Procurements and Contracts.

Additionally, PwC in its role as independent auditor of the company's financial statements was not engaged to review or express an opinion of the adequacy of the company business continuity plans. Rather, as is standard practice in such engagements, PwC did complete a checklist intended to insure that the auxiliary organization follows standard business practices in a wide variety of areas. The PwC management comment in the audit of the 2000-01 financial statements suggesting that the auxiliary organization update its business continuity planning was simply an outcome of the completion of that check-list.

Student Aid established the auxiliary organization for the purpose of providing operational and administrative services to participate in the loan program.

The implementation and effectuation of the auxiliary organization shall be carried out to enhance the administration and delivery of student aid programs and services. The auxiliary structure allows for flexibility in areas of business such as hiring, purchasing, and technology enhancements/requirements to meet current standard business requirements within the loan program.

Student Aid will examine the state contracting rules and if any are applicable as models for best practices, will discuss these with its auxiliary organization.

DEPARTMENT OF HEALTH SERVICES

Reference Number: 2002-19-6

CONDITION

The Fund does not have, but needs an employee or contractor who can convert the various special revenue funds of the program which are reported on a budgetary (encumbrance) basis of accounting to a proprietary fund type presentation on an accrual basis of accounting for external financial reporting of the program.

CRITERIA

Review of the Capitalization Grants for Drinking Water State Revolving Fund (Fund) identified the following requirement relating to reporting:

One of the primary objectives of the EPA is to provide a permanent financing institution in each state, much like a bank or loan company. The accounting and the financial statements should be similar to those of a financial institution. As such, the preferred method of accounting for the activities of the Fund is as a proprietary (enterprise) fund as outlined in the the Environmental Protection Agency's *Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs*, revised September 2002.

RECOMMENDATION

The Fund should contact the Bureau of State Audits or other experienced consultants in this area for assistance in training current staff.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Fund will review the recommendation and follow up with the Bureau of State Audits to discuss the conversion issues and determine the appropriate course of action.

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Compliance Issue Related to All Federal Grants

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IDENTIFYING PROGRAM EXPENDITURES

Reference Number:	2002-12-1
Federal Program:	All Programs
Category of Finding:	Reporting

CRITERIA

In our review of federal reports, we determined the following were among state and federal compliance requirements:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires that the State prepare a schedule showing total expenditures for the year for each federal program. Further, OMB Circular A-133 requires that the State identify and audit all high-risk Type A federal programs. Type A programs are those exceeding .15 percent of total federal program moneys the State expends during the fiscal year. The California Government Code, Section 13300, assigns the Department of Finance (Finance) the responsibility for maintaining a complete accounting system to ensure that all revenues, expenditures, receipts, disbursements, resources, obligations, and property of the State are properly tracked and reported.

CONDITION

Because of limitations in its automated accounting systems, the State has not complied with the provision of OMB Circular A-133 requiring a schedule showing total expenditures for each federal program. As a result, the schedule (beginning on page 157) 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 none of them exceeded the Type A threshold.

RECOMMENDATION

As priorities and resources permit, Finance should modify the State's accounting system to separately identify expenditures for all major programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Finance has responded that although the State, on a statewide basis, reports federal receipt totals, each individual state entity reports expenditures by grant to its federal cognizant agency. Finance states that the State's accounting system will require substantial modification to compile expenditure information to meet all federal and state requirements. Because the State has limited resources, Finance has no plans at this time to enhance the State's accounting system or to implement a new system.

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

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U.S. DEPARTMENT OF AGRICULTURE

Reference Number:	2002-2-2
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2000 7CA700CA7; 2001
Category of Finding:	Allowable Costs
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program) identified the following compliance requirements related to allowable costs:

The Code of Federal Regulations, Title 7, Section 246.14(d), requires prior approval from the United States Department of Agriculture's Food and Nutrition Service (FNS) for costs for automated data processing (ADP) hardware or software. Under the FNS Handbook 901, Section 5010, the FNS has authorized state agencies administering the WIC program to make data-processing acquisitions with a total project cost of up to $24,999 without prior approval. For ADP acquisitions exceeding $24,999 in total project costs, the WIC Program must obtain prior approval from the FNS before the expense is incurred.

CONDITION

Although it has procedures in place to ensure that it obtains prior approval from FNS for ADP project costs exceeding $24,999, the Department of Health Services (Health Services) does not always adhere to them. For two projects with total ADP equipment costs exceeding $24,999, Health Services did not obtain prior approval from FNS. In the first instance, a local agency split a single purchase of $48,700 worth of ADP equipment into two separate purchases in order to circumvent the $24,999 threshold for prior approval. The analyst who reviewed these purchases told us that she received very little formal training and did not recall receiving any training documents to guide her. In the second instance, a request for at least $82,400 worth of ADP equipment was mislabeled as Modular Office Furniture and was therefore not

submitted for prior approval from FNS. By not following FNS procurement procedures, Health Services increases the risk that WIC Program funds may be used for unallowable costs.

RECOMMENDATIONS

DHS should be more diligent in its review of requests for ADP equipment in order to ensure that it follows FNS procurement procedures and obtains approval before incurring ADP project costs exceeding $24,999. Health Services should also ensure that it properly trains its contract analysts and provides them with sufficient guidance to properly perform their duties.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services states that it is very diligent in its efforts to request U.S. Department of Agriculture (USDA) approval of all ADP orders over $25,000. As a part of this effort, it is continually developing new procedures to improve its procurement process. In August 2002, Health Services distributed new Contract Management Binders (CMB) to the local agencies. The CMB includes a Procurement Decision Table that guides them through the approval process. By May 2003, Health Services will complete a desk procedure manual and provide additional training for WIC Branch analysts that review local agency procurements. The manual will include:

- A procurement process decision guide matrix;
- A subsection on recognizing and addressing circumvention of the procurement process;
- Procedures to implement the USDA 60 day notification rule for ADP procurements above $5,000 base cost, but less than $25,000; and
- Updates to the tracking and internal routing process.

Reference Number:	2002-3-3
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2000 7CA700CA7; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program) identified the following compliance requirements related to cash management:

The Code of Federal Regulations, Title 31, Section 205.9, authorizes states to enter into a Treasury-State Agreement (agreement) with the federal Department of the Treasury to establish rules and procedures for the transfer of funds between the federal government and the State. For those programs receiving more than $87 million in federal grant awards, California's agreement for fiscal year 2001-02 specifies which of the 11 available methods state departments must use to transfer funds from the federal government.

The agreement identifies the "modified zero balance accounting" method as the one to be used by the WIC program to transfer federal funds to pay for state-issued food vouchers redeemed to the State by grocery and other stores. Under this transfer method, the Department of Health Services (Health Services) must estimate the amount of federal funds it needs daily to redeem food vouchers. Two days in arrears, Health Services must also account for the difference between the estimated and actual amounts by adjusting that day's transfer. The agreement states that neither the federal government nor the State will incur an interest liability for minor adjustment amounts.

CONDITION

Health Services did not use the agreed-upon method for transferring federal funds to pay for redeemed food vouchers for the WIC Program. Rather than using the "modified zero balance accounting" method as the agreement required, Health Services used the "reimbursement" method. For the 14 claims we sampled, Health Services first used state funds to make payments and subsequently transferred federal funds to reimburse the State. Although the transfer method Health Services used incurs no interest liability to be paid to the federal government, the State incurs a financial loss because the money used to pay for the redeemed vouchers is not in the State's accounts earning interest. Every dollar earned from interest reduces the need for taxes or other revenue by an equal amount. Our review of a sample of 14 WIC Program claim schedules totaling nearly $44 million showed that the State lost an estimated $23,000 in interest from the time Health Services used state funds to pay the claims until it transferred the corresponding federal funds. With a range of one to 14 days, Health Services took an average of six days to obtain federal reimbursing funds for these claims. During fiscal year 2001-02, Health Services spent $577 million to redeem food vouchers for the WIC Program. Health Services believes that its deviation from the agreement results in no lost interest; however, as explained above, the State does indeed lose interest earnings.

RECOMMENDATION

Health Services should comply with the provisions of the agreement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees it has deviated from the State Treasury Agreement. Effective July 1, 2003, the modified zero balance accounting method will be used for CMIA purposes.

Reference Number:	2002-9-7
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Social Services

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

CRITERIA

Our review of the Emergency Food Assistance Program identified the following requirements related to suspension and debarment:

The Code of Federal Regulations, Title 7, Section 3017.225, prohibits the State from contracting with any party that is suspended or debarred or otherwise ineligible to participate in federal assistance programs. In addition, Section 3017.510 requires the State to obtain certifications from participating organizations indicating that they are not suspended, debarred, ineligible, or voluntarily excluded from transactions by any federal agency.

CONDITION

The Department of Social Services (Social Services) did not require 46 of its 51 subrecipients of the Emergency Food Assistance Program to submit suspension and debarment certifications. These 46 subrecipients were nonprofit organizations; the other five subrecipients were county-run organizations. When Social Services does not obtain the required certifications, it risks unknowingly allowing suspended or debarred parties to participate in the federal program. For these 46 subrecipients, we used an alternative test to determine that they were not suspended or debarred.

RECOMMENDATION

Social Services should ensure that it obtains the necessary suspension and debarment certifications from all subrecipients before approving their participation in the Emergency Food Assistance Program.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Social Services concurs. Social Services will obtain the required suspension and debarment certifications from its subrecipients by making the certifications part of the Memoranda of Understanding (MOU) between Social Services and these subrecipients. Existing MOUs with these subrecipients expire on September 30, 2004. Social Services will have suspension and debarment certifications included in the agreements that take effect on October 1, 2004.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.568
Federal Program Title:	Emergency Food Assistance Program (Administrative Costs)
Federal Award Numbers and Calendar Years Awarded:	7CA810CA8; 2000 7CA810CA8; 2001

Federal Catalog Number:	10.569
Federal Program Title:	Emergency Food Assistance Program (Food Commodities)
Federal Award Numbers and Calendar Years Awarded:	TEFAP-2000-01, FD-5-6, 2001 TEFAP-2001-02, FD-5-06-3, 2002

Reference Number:	2002-13-4
Federal Catalog Number:	10.558
Federal Program Title:	Child and Adult Care Food Program
Federal Award Numbers and Calendar Years Awarded:	7CA300CA3; 2000 7CA300CA3; 2001

Category of Finding: Subrecipient Monitoring

State Administering Department: Department of Education

CRITERIA

Our review of the Child and Adult Care Food Program (food program) determined that the following federal requirements relate to subrecipient monitoring:

The Code of Federal Regulations, Title 7, Section 226.6(l)(3), requires states to ensure that newly participating sponsors with five or more child care facilities or adult day care facilities are reviewed within the first 90 days of operation.

CONDITION

The Department of Education (Education) did not adequately fulfill its subrecipient monitoring responsibilities for the food program. Specifically, we reviewed seven new sponsors that Education approved between July 1, 2001, and April 1, 2002, to participate in the food program. We found that Education had not conducted an administrative review for four sponsors within the first 90 days of operation. The reviews were from one to seven months overdue. When Education does not conduct timely reviews of its new sponsors, it reduces assurance that sponsors are aware of and have the procedures in place to comply with federal food program regulations and administrative requirements.

In an August 2002 report, the United States Department of Agriculture (USDA) noted a similar finding. Education stated it is implementing corrective action in response to the USDA's finding. The corrective action includes determining whether applicants have five or more sites and, after assigning staff to conduct the 90-day reviews, tracking the status of the reviews. In addition, Education is pursuing enhancement of its food program databases to capture the 90-day review process data.

RECOMMENDATIONS

Education should ensure implementation of its corrective action and should continue to pursue enhancement of its food program databases to ensure it reviews all new participating sponsors with five or more sites within the first 90 days of operation.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education has taken the following steps to ensure that it reviews new sponsors with five or more sites within the first 90 days of operation:

- Upon receipt of a new Child and Adult Care Food Program application, Nutrition Services Division's (NSD) Resources and Information Management Unit (RIM) records the number of applicant sites on an application tracking sheet.
- RIM forwards the application and application tracking sheet to the Field Services Unit (FSU) for processing.
- An FSU supervisor evaluates the number of sites listed on the application tracking sheet, determines the review requirements, and enters the application data in the new/pending application log.
- When NSD approves the application, if the sponsor has five or more sites, the FSU supervisor assigns staff to conduct the administrative review within 90 days of the application effective date.
- FSU maintains a spreadsheet on the status of 90-day reviews. At each monthly staff meeting, FSU supervisors review the status of assignments with staff. When appropriate, FSU supervisors assign additional staff to ensure timely completion of the review.
- When the 90-day review is completed, FSU sends a review transmittal form to RIM for input of the sponsor's name, effective date, number of sites, and date of the 90-day review into the FSU workload tracking database.

In addition, Education has requested that the Management Systems Division, within the Child, Youth and Family Services Branch, enhance the Child and Adult Care Food Program sponsor database and the FSU workload tracking database to capture the 90-day review information. These actions will allow FSU supervisors and NSD management to review monthly status reports, and take prompt action to ensure compliance with federal regulations.

Reference Number:	2002-13-8
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Social Services

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

CRITERIA

Our review of the Emergency Food Assistance Program identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the requirements the State must follow when it passes federal funds through to

subrecipients. Section 400(d) requires the State to ensure that subrecipients expending $300,000 or more in federal assistance meet applicable audit requirements, including the submission of an audit report to the State within nine months following the end of the audit period. Also, the State is required to issue management decisions on audit findings within six months of receiving audit reports. Further, Section 400(d) requires the State to provide its subrecipients with information such as the federal grant title and number, award year, and the name of the federal agency.

CONDITION

The Department of Social Services (Social Services) did not have an adequate system to ensure it met the OMB Circular A-133 requirements it must follow when it passes federal funds through to subrecipients. Specifically, Social Services did not have procedures for determining whether all of its 46 nonprofit subrecipients were required to submit audit reports. Such steps may include requiring each subrecipient to either inform Social Services that it did not expend $300,000 or more in total assistance from all federal programs or to submit an appropriate audit report, and identifying those nonprofit subrecipients to which it provided $300,000 or more in federal assistance. Based on information available at Social Services, we determined that Social Services provided $300,000 or more in federal assistance during fiscal year 2000-01 from the Emergency Food Assistance Program alone to at least 13 of the 46 nonprofit subrecipients. Further, Social Services did not have adequate procedures for ensuring that it obtained audit reports from all subrecipients required to submit them. Of the 13 subrecipients receiving at least $300,000, Social Services obtained audit reports from only six. Moreover, Social Services did not have procedures for ensuring that it issued management decisions when audit reports disclosed findings. One of the six audit reports that Social Services received contained findings related to the Emergency Food Assistance Program. However, as of April 2003, Social Services had not issued the required management decision, which was due by June 2002. Finally, Social Services did not provide any of its nonprofit subrecipients with the required grant-related information, such as the federal grant title and number, the award year, and the name of the federal agency.

Without an effective system to identify nonprofit subrecipients required to have audits and to track the prompt receipt of these required audit reports, Social Services has reduced assurance that its nonprofit subrecipients are spending federal assistance according to applicable laws and regulations. Furthermore, when it does not issue management decisions on audit findings, Social Services cannot ensure that its subrecipients are taking prompt and appropriate action to address audit findings. Lastly, when Social Services does not provide subrecipients with information related to the federal grant, Social Services cannot assure that subrecipients will identify for their independent auditors all their federal awards for audits conducted under OMB Circular A-133.

RECOMMENDATIONS

Social Services should develop a system to ensure it identifies those nonprofit subrecipients required to submit audit reports and that it obtains audit reports from those subrecipients required to submit them. Additionally, it should promptly issue the required management decisions on audit findings affecting the Emergency Food Assistance Program. Finally, Social Services should ensure that it informs its subrecipients of the required federal grant information.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Social Services concurs. Social Services requested A-133 audit reports from the seven subrecipient agencies identified by the auditors and by now Social Services has received and reviewed five of these delinquent reports. In response to this finding, Social Services is developing written procedures to ensure that all Emergency Food Assistance Program subrecipient agencies are notified of the requirements for procuring annual A-133 audits, for submitting resultant audit reports timely to Social Services, and for taking timely corrective action to resolve any audit findings reported. These procedures will also ensure that Social Services staff review all audit reports, and follow up and issue timely management decisions regarding any Emergency Food Assistance Program findings reported. Finally, these procedures will ensure that all subrecipients receive annual, written notification of the required grant information.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.568
Federal Program Title:	Emergency Food Assistance Program (Administrative Costs)
Federal Award Numbers Calendar Years Awarded:	7CA810CA8, 2000 7CA810CA8, 2001

Federal Catalog Number:	10.569
Federal Program Title:	Emergency Food Assistance Program (Commodities)
Federal Award Number and Calendar Year Awarded:	TEFAP-2000-01, FD-5-6, 2001

U.S. DEPARTMENT OF AGRICULTURE
U.S. DEPARTMENT OF LABOR
U.S. DEPARTMENT OF EDUCATION
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES
U.S. SOCIAL SECURITY ADMINISTRATION

Reference Number: 2002-3-7

Category of Finding: Cash Management

State Administering Department: Department of Finance

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

CRITERIA

We determined that the following requirements relate to compliance with the Cash Management Improvement Act:

The Code of Federal Regulations, Title 31, Section 205.15(a), requires the State to submit an annual report to the U.S. Department of the Treasury that accounts for the interest liabilities of the State's most recently completed fiscal year. This report must include the total federal and state interest liability for each program subject to the Cash Management Improvement Act Agreement (CMIA agreement) between the U.S. Department of the Treasury and the State, as well as the net total interest owed by the State or the federal government. Section 205.15(d) requires an authorized state official to certify the accuracy of the State's annual report.

Additionally, the CMIA agreement, Section 9.7.13, requires the State to calculate both state and federal interest liabilities on all administrative costs, including payroll and state operating costs, and to incorporate these calculations into the total interest liability information contained in the annual report. Finally, the State and the federal Financial Management Service have agreed that the State should record payroll expenditures on the warrant issue date.

CONDITION

The Department of Finance (Finance) requires state departments to report information related to the receipt and disbursement of federal funds of selected federal programs so that it can calculate interest liabilities under the CMIA agreement. Finance uses a daily balance method to calculate interest liabilities on administrative costs. However, we found that Finance did not ensure that it recorded all expenditures to the appropriate dates for 18 programs, 15 of which we audited this year, in its

interest-liability calculations. For 12 of these 18 programs, the error pertained to one month's payroll expenditures that Finance recorded as paid one day later than the actual issue date of the warrants. Although the effect of the errors on all but one of the 18 programs is less than $10,000, in the aggregate, Finance calculates that it overstated the State's net interest liability in the fiscal year 2001-02 annual report by more than $22,700.

RECOMMENDATIONS

Finance should correct the errors contained in the State's fiscal year 2001-02 annual report by adjusting the interest liabilities of the affected programs in the fiscal year 2002-03 report. Finance should also ensure that interest liabilities contained in future annual reports are calculated using the agreed upon methodology.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Finance agrees with the finding. It states that the overstated state interest liability will be reported and adjusted as a prior year adjustment in the fiscal year 2002-03 CMIA Annual Report that will be submitted in December 2003.

Finance also states that it has implemented procedures that will provide greater accuracy, reducing the possibility of errors. Finance will continue its ongoing efforts to reduce errors by improving internal procedures and analyzing the information reported by state departments.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.558
Federal Program Title:	Child and Adult Care Food Program
Federal Award Numbers and Calendar Years Awarded:	7CA300CA3; 2000 7CA300CA3; 2001

Federal Catalog Number:	10.561
Federal Program Title:	State Administrative Matching Grants for Food Stamp Program
Federal Award Numbers and Calendar Years Awarded:	7CA4004CA; 2001 7CA4004CA; 2002 7CA400CA4; 2001 7CA400CA4; 2002 7CA420CAX; 2002

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-11518-01-55; 2001

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Numbers and Calendar Years Awarded:	UI10924FM0; 2001 UI10924FM0; 2002 UI109240055; 2001 UI109240055; 2002

Federal Catalog Number:	17.259
Federal Program Title:	Workforce Investment Act Youth Activities (Workforce Investment Act Formula Youth)
Federal Award Number and Calendar Year Awarded:	AA-112240-00-50; 2001

Federal Catalog Number:	17.260
Federal Program Title:	Workforce Investment Act Dislocated Workers
Federal Award Number and Calendar Year Awarded:	AA-112240-00-50; 2001

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A010005; 2001

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—Basic State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A010005; 2001

Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Number and Calendar Year Awarded:	H027A010116; 2001

Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A010005; 2001

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.558
Federal Program Title:	Temporary Assistance for Needy Families
Federal Award Numbers and Calendar Years Awarded:	G-0101CATANF; 2001 G-0201CATANF; 2002

Federal Catalog Number:	93.658
Federal Program Title:	Foster Care—Title IV-E
Federal Award Numbers and Calendar Years Awarded:	0101CA1401; 2001 0201CA1401; 2002

Federal Catalog Number:	93.659
Federal Program Title:	Adoption Assistance
Federal Award Numbers and Calendar Years Awarded:	0101CA1407; 2001 0201CA1407; 2002

Federal Catalog Number:	93.959
Federal Program Title:	Block Grants for Prevention and Treatment of Substance Abuse
Federal Award Numbers and Calendar Years Awarded:	01B1CASAPT-04; 2000 02B1CASAPT-04; 2001

U.S. SOCIAL SECURITY ADMINISTRATION

Federal Catalog Number:	96.001
Federal Program Title:	Social Security—Disability Insurance
Federal Award Numbers and Calendar Years Awarded:	04-0104CADI00; 2000 04-0204CADI00; 2001

U.S. DEPARTMENT OF AGRICULTURE
U.S. DEPARTMENT OF EDUCATION
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number:	2002-3-8
Category of Finding:	Cash Management
State Administering Departments:	Department of Finance State Controller's Office

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

CRITERIA

Our review of federal programs identified the following compliance requirements related to cash management:

The Code of Federal Regulations, Title 31, Part 205, provides the cash management requirements for federal grant programs. Subpart B of Part 205 pertains to those federal grant programs not covered by the Cash Management Improvement Act agreement (CMIA agreement) between the State and the U.S. Department of the Treasury. This subpart requires the State to limit its cash advances from the U.S. Department of the Treasury to the minimum amounts necessary to meet immediate cash needs. It also requires that the timing of transfers be as close as administratively feasible to the State's actual cash outlay. Because Part 205 does not define the specific number of days between the transfer of federal funds and their subsequent disbursement that constitute "immediate cash needs," we used as a benchmark the three business days the U.S. Department of Health and Human Services uses.

CONDITION

The State does not always limit transfers of federal funds to the immediate cash needs for those federal grants not covered by the CMIA agreement. Our audit work at four departments revealed that the State averaged nearly six days from the date that a department transferred federal funds into its accounts until the date the State Controller's Office (Controller's Office) issued warrants related to those funds. For instance, for one grant we reviewed at the Department of Education, the State averaged nine days while for another grant it averaged five. The State averaged seven days for a federal grant we reviewed at the Department of Developmental Services and seven days for two federal grants we reviewed at the Department of Aging. The State also averaged four days for a federal grant we reviewed at the Department of Community Services and Development. When calculating our

averages, we included the first three business days and all remaining calendar days that elapsed between the transfer and the disbursement of federal funds. For all six grants, the average number of days from transfer to disbursement of federal funds was six; the number of days between the two actions ranged from 0 to 44.

Our review also disclosed that three of the four departments on average delayed transferring their federal funds until after the Controller's Office had received their claim schedules. The Department of Education delayed transferring its federal funds an average of 2.4 days for one of its grants and an average of .4 days for the other. Both the Department of Aging and the Department of Community Services and Development delayed the transfer of federal funds for their grants by an average of about 1.25 days. Only the Department of Developmental Services transferred the federal funds for its grant before the Controller's Office had received its claim schedules; it did so on average about 1.6 days beforehand. Overall, for the six grants we reviewed, the Controller's Office averaged eight days to process claim schedules after it received them, with averages per grant ranging from seven to 10 days.

When the State does not minimize the number of days between the transfer and disbursement of federal funds for grant programs not covered by the CMIA agreement, it will earn interest on those federal funds that it otherwise would not have earned had it complied with federal regulations. In our sample of 174 claims for the six federal grants cited above, we estimate that the State earned nearly $40,000 in interest during fiscal year 2001-02 while it held those federal funds in state accounts. Although the federal government may not seek to recoup these interest earnings, the State could face other administrative consequences. The Code of Federal Regulations states that neither the federal government nor the State will incur an interest liability for transfers of funds for grants that are not covered by the CMIA agreement. However, the Code of Federal Regulations also states that if the State demonstrates an unwillingness or inability to limit the transfers for these types of federal grants to its immediate cash needs, the federal government can require the State to include additional programs under the CMIA agreement, which could increase the State's record-keeping requirements and would increase the number of programs subject to the state's interest liability calculations.

RECOMMENDATION

For grants that are not covered by the CMIA agreement, the Department of Finance and the State Controller's Office should develop and implement a cost-effective, administratively feasible method to more effectively reduce the number of days between the transfer of federal funds and issuance of the related warrants.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

The Department of Finance (Finance) does not agree with the finding. Finance believes State departments do limit the drawdown of federal funds to the actual, immediate cash requirements of the State. The payment of claims requires the timely coordination of transactions involving at least three State departments. State

departments initiate the payment process, the State Treasurer's Office receives the federal funds, and the State Controller's Office audits and pays the claims. State departments must estimate when the State Controller's Office will process the claim for payment and draw the federal funds as close as possible to the actual disbursement date. Given the State accounting processes and restraints, in addition to the State Constitutional requirement that federal funds be on hand by the time the disbursement is made, we believe the average six day processing time by the State Controller's Office is reasonable and within the administratively feasible parameters established for Subpart B programs covered under 31 CFR Part 205.

Finance does agree with the recommendation to meet with the State Controller's Office to determine how further improvements can be made in the timely receipt and disbursement of federal funds.

The State Controller's Office states that, as the Bureau of State Audits noted, the Code of Federal Regulations, Title 31, Part 205, does not define a specific number of days between the transfer of funds and their subsequent disbursement that constitutes "immediate cash needs." Nevertheless, the State Controller's Office is aware that the federal regulations also provide that if a state demonstrates an unwillingness or inability to limit transfers of funds for those federal grants covered by Part B of the regulations to immediate cash needs, the federal government may require that state to include additional programs under the CMIA agreement.

The State Controller's Office states that it plans to meet with the Department of Finance to develop a cost-effective and administratively feasible method to reduce the number of days between the transfer of federal funds and the issuance of related warrants for those federal grants covered by Part B of the federal regulations.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.559
Federal Program Title:	Summer Food Service Program for Children
Federal Award Number and Calendar Year Awarded:	7CA300CA3; 2001

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.173
Federal Program Title:	Special Education—Preschool Grants
Federal Award Number and Calendar Year Awarded:	H173A010120; 2001

Federal Catalog Number:	84.181
Federal Program Title:	Special Education—Grants for Infants and Families with Disabilities
Federal Award Number and Calendar Year Awarded:	H181A010037; 2001

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:	02-01-AA-CA-1320; 2000 02-02-AA-CA-1320; 2001

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:	02-01-AA-CA-1712; 2000 02-02-AA-CA-1713; 2000 02-02-AA-CA-1712; 2001 02-02-AA-CA-1713; 2001

Federal Catalog Number:	93.569
Federal Program Title:	Community Services Block Grant
Federal Award Number and Calendar Year Awarded:	G-01B1CACOSR; 2000

U.S. DEPARTMENT OF AGRICULTURE
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number: 2002-3-16

Category of Finding: Cash Management

State Administering Department: Department of Social Services

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

CRITERIA

Our review of federal programs identified the following compliance requirements relating to cash management:

The Code of Federal Regulations, Title 31, Part 205, Subpart B, provides the cash management requirements for federal programs not covered in the Cash Management Improvement Act agreement between the U.S. Department of the Treasury and the State. Section 205.20 requires the State to limit the cash advances from the U.S. Department of the Treasury to the minimum amounts needed.

CONDITION

The Department of Social Services (Social Services) did not always limit cash advances of federal funds to the minimum amounts needed. Specifically, for the Emergency Food Assistance Program, Social Services had excess monthly balances of federal funds on hand in the State's accounts for April through June 2002 that ranged from $329,000 to $976,000 more than necessary to cover monthly expenditures. In April 2002, Social Services transferred in an advance of $1.2 million in federal funds for the program. It based the size of this advance on the maximum amount it believed would be necessary to cover monthly expenditures incurred from April through June 2002. During this three-month period, however, monthly expenditures ranged from only $224,000 to $846,000. The excess balances of federal funds occurred because Social Services did not charge all or a portion of the expenditures it incurred against the advance; instead it transferred in additional federal funds each month to reimburse itself for the prior month's expenditures. Social Services eventually liquidated the $1.2 million advance between August and October 2002, four to six months after receiving it.

Social Services also had similarly high monthly balances that ranged from $84,000 to $476,000 during April through June 2002 for the federal Chafee Foster Care Independent Living program. In April 2002, Social Services transferred in an advance of $500,000 in federal funds for this program. Monthly expenditures for this program during April through June 2002, however, ranged from only $24,000 to $336,000.

Social Services liquidated this $500,000 advance by August 2002. We calculate that the State earned about $7,300 in interest on the excess federal funds Social Services held for these two programs from April through September 2002.

RECOMMENDATION

Social Services should limit advances of federal funds to the minimum amounts needed for the Emergency Food Assistance and the Chafee Foster Care Independent Living programs. To accomplish this objective, Social Services should reassess the level of federal funds it needs in light of actual expenditure activity.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Social Services concurs with the recommendation that advances of federal funds should be limited to the amounts needed for the Emergency Food Assistance Program and the Independent Living Program. Social Services believes its cash management practices do minimize the amounts of federal funds advanced to meet the program costs. However, Social Services does not believe this finding accurately represents the cash management practice for the entire State fiscal year.

Social Services uses a General Fund Clearing Account to initially pay all of its operational costs. For the first 8 to 9 months of the year, the State General Fund initially pays the operational costs of the Emergency Food Assistance Program and is subsequently reimbursed with federal funds on a monthly basis. However, at the end of the State fiscal year the federal funds need to be advanced due to insufficient General Funds available to cover the Federal share of the monthly operational costs. Based on the aforementioned practice, if these grants were covered under the CMIA State/Treasury agreement, the Federal government would have incurred an interest liability for the first 9 months of approximately $27,778.

The monthly advance is estimated on actual expenditure trends during the year, outstanding obligations, and past year history. Historical trends indicate that expenditures are usually highest during the last quarter of the state fiscal year and that for the Emergency Food Assistance Program the entire grant will be utilized. Our advance is reflective of such considerations. In addition, A-87 (Attachment C, Part G-2) allows for a working capital reserve, up to 60 days, in addition to the full recovery of costs. The General Fund Clearing Account functions much like an internal service fund since state funds are not intentionally appropriated to "float" expenditures applicable to federal funds. Specifically for state fiscal year 2001/02 State Operations, the General Fund appropriation was $95,932,000 with the Federal Trust Fund appropriation at $308,902,500. The amount of State funds available clearly dictates the frequency and amount of federal funds drawn. This disparity of appropriated federal funds to general funds makes it impossible for federal claims to be paid up front with General Fund's for the entire state fiscal year.

Based on the aforementioned conditions, Social Services believes its cash management practices relative to these end of year federal estimates are reasonable and equitable.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Although Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), Attachment C, allows working capital reserves for internal service funds, it pertains to a state's central service cost allocation plan. Social Services' rationale ignores the critical fact that its General Fund clearing account is not an internal service fund. Because the payments Social Services makes through the General Fund clearing account for these two federal programs are not related to an internal service activity, the provisions of OMB Circular A-87, Attachment C, do not apply to its use of the advance of federal funds.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.568
Federal Program Title:	Emergency Food Assistance Program (Administrative Costs)
Federal Award Numbers and Calendar Years Awarded:	7CA810CA8, 2000 7CA810CA8, 2001

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.674
Federal Program Title:	Chafee Foster Care Independent Living
Federal Award Numbers and Calendar Years Awarded:	G-0001CA1420; 1999 G-0101CA1420; 2000 G-0201CA1420; 2001

Reference Number:	2002-13-5
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

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

CRITERIA

Our review of federal programs identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the audit requirements for recipients of federal funds. Sections 200 and 320 require subrecipients spending $300,000 or more annually in federal awards to submit audit reports to the State when the reports address findings related to the federal awards that the State administers. Audit reports are due within nine months of the end of the audit period. Further, Section 400(d) requires the State to ensure the subrecipients meet the audit requirements, to issue management decisions on audit findings within six months of receiving audit reports, and to make sure subrecipients take appropriate and timely corrective action.

CONDITION

The Department of Health Services (Health Services) did not always promptly receive all audit reports from its nonprofit subrecipients. Specifically, Health Services received audit reports that were 43 to 442 days late from four of the 20 nonprofit subrecipients that we reviewed who participated in the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program). Similarly, it received audit reports that were 44 to 215 days late from five of the 19 nonprofit subrecipients that we reviewed who participated in the HIV Care Formula Grants program; it received audit reports from four other nonprofit subrecipients up to 11 days late. Finally, Health Services received audit reports that were 131 and 220 days late from two of the nine nonprofit subrecipients that we reviewed who participated in the Maternal and Child Health Services Block Grant to the States program.

Health Services did not always receive the required audit reports on time because it did not always adhere to its process for obtaining these reports. For the WIC Program, Health Services did not send the third of its four reminder and late notices to one nonprofit subrecipient, nor did it send the fourth reminder and late notice to three of the four nonprofit subrecipients who submitted their reports late. After initially receiving from the fourth subrecipient a report in 2001 that did not meet the requirements of OMB Circular A-133, Health Services finally received this subrecipient's A-133 audit report in January 2003. For the HIV Care Formula Grants program, Health Services did not send the first of two reminder letters to subrecipients with late audit reports, and it issued the second letter to one subrecipient six months after its audit report was due. For the Maternal and Child Health Services Block Grant to the States program, Health Services sent its series of four reminder and late notices on the same date to one nonprofit subrecipient with a late audit report rather than send each notice on its designated date. For the other nonprofit subrecipient with a late report, Health Services sent a single late notice eight months after the audit report was due.

We also observed a number of other weaknesses in Health Services' process for ensuring that nonprofit subrecipients receiving federal funds comply with the audit requirements of OMB Circular A-133. Specifically, the tracking log that Health Services used to monitor subrecipient compliance with audit requirements did not identify 13 of the WIC program's 42 subrecipients. Further, although one unit within Health Services received an audit report by July 2002 from a nonprofit subrecipient, the unit that actually tracks the receipt of the audit reports showed that it had never received this nonprofit subrecipient's report. Also, Health Services received inadequate audit reports from two subrecipients that expended more than $300,000 in federal funds. One subrecipient submitted a financial audit report rather than an OMB Circular A-133 audit report while the other omitted the required schedule of findings and questioned costs from its audit report. Finally, Health Services had not issued, as of December 2002, the management decision for a WIC program finding contained in an audit report that it had received from a subrecipient more than 17 months earlier.

Without an effective system to appropriately follow up on delinquent audit reports, Health Services cannot ensure that its nonprofit subrecipients are meeting audit requirements that are designed to ensure that federal funds are properly spent. Further, when it does not issue management decisions on audit findings that affect its programs, Health Services cannot ensure that its nonprofit subrecipients are taking prompt and appropriate action to address audit findings.

RECOMMENDATIONS

Health Services should ensure that its staff members follow its system for following up on delinquent audit reports from nonprofit subrecipients and that the information contained in this system is accurate and complete. These steps should include ensuring that it sends reminder and late notices when required, properly identifies all subrecipients in its tracking system, ensures that all audit reports meet applicable requirements, and issues the required management decisions within six months of receiving an audit report.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services concurs with the finding. Specifically, the Maternal and Child Health (MCH) Branch, which coordinates the single agency tracking function for the Primary Care and Family Health Division, has taken measures to improve upon the system. MCH convenes regular meetings with members from each Branch, including Women, Infant and Children, which are required to comply with the federal requirements. The purpose of these meetings is to share information, discuss processes, and implement changes such as those identified by the Bureau of State Audits. And as the single point for coordinating this activity, MCH has recently implemented an automated reminder system to track the status of all subrecipient files. This will help facilitate issuing management decisions within the six-month timeframe.

The Office of AIDS (OA) also concurs with the finding. OA has developed and will continue to develop procedures to identify, track, and monitor contractors. Additionally, the OA recently convened a division-wide workgroup to improve OA's responsibilities of OMB Circular A-133 audit requirements. The OA will make an extra effort to ensure OA acts timely and will follow-up on late A-133 audit contractors.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2000 7CA700CA7; 2001

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.917
Federal Program Title:	HIV Care Formula Grants
Federal Award Number and Calendar Year Awarded:	2X07 HA 00041-11; 2001

Federal Catalog Number:	93.994
Federal Program Title:	Maternal and Child Health Services Block Grant to the States
Federal Award Numbers and Calendar Years Awarded:	6 B04 MC 00336-05; 2000 6 B04 MC 00336-06; 2001

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Reference Number:	2002-9-4
Federal Catalog Number:	14.228
Federal Program Title:	Community Development Block Grant/State's Program
Federal Award Numbers and Calendar Years Awarded:	B-00-DC-06-0001; 2000 B-01-DC-06-0001; 2001
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of the Community Development Block Grant/State's Program (CDBG) identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 24, Section 24.225, prohibits the State from knowingly doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. Further, Section 24.510 requires the State to obtain signed certifications from participating organizations regarding debarment, suspension, ineligibility, and involuntary exclusion.

CONDITION

The Department of Housing and Community Development (Housing) does not require subrecipients of CDBG program funds to submit suspension and debarment certifications. When Housing does not obtain the required certifications, it risks unknowingly allowing suspended or debarred parties to participate in the federal program. For the 40 transactions we reviewed, we used an alternative test to determine that the subrecipients were not suspended or debarred.

RECOMMENDATION

Housing should establish procedures to ensure that subrecipients submit suspension and debarment certifications before it approves their participation in the CDBG program.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with the finding. Housing says it revised the Statement of Assurances to include a certification that the city or county applying for funding is not suspended or debarred from receiving a federally funded contract. This revision was included in the 2002-03 CDBG Planning/Technical Assistance Allocation application. Inadvertently, the updated version of the Statement of Assurances was not used for the General/Native American/Colonias and Economic Development Allocation applications.

Housing says it will develop a separate certification to be used by current year applicants to verify that the city or county applying for funds is not currently debarred or suspended. No award of funds will be made without receipt of the certification. In the future, all CDBG applications will include the updated Statement of Assurances.

Reference Number:	2002-12-5
Federal Catalog Number:	14.228
Federal Program Title:	Community Development Block Grant/State's Program
Federal Award Number and Calendar Year Awarded:	B-00-DC-06-0001; 2000
Category of Finding:	Reporting
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of the Community Development Block Grant/State's Program (CDBG) identified the following compliance requirement:

The United States Code, Title 42, Section 5304(e), states that each grantee shall submit a performance and evaluation report concerning the use of funds made available under Section 5306 of this title.

The Code of Federal Regulations, Title 24, Section 91.520(a), states that the performance report must include a description of available resources. Section 91.520(c) states that for CDBG program recipients, the report shall include a description of the use of CDBG program funds.

CONDITION

We discovered numerous errors in the financial data that the Department of Housing and Community Development (Housing) included in its Consolidated Annual Performance and Evaluation Report (report) for fiscal year 2000-01. Specifically, the table showing the breakdown of the CDBG program grant into its subgrant components misreported nine of the 10 figures. For example, Housing reported that the amount it allocated to the Economic Development Allocation—Over-the-Counter component was $44,179,074 and the amount it allocated to the Colonias component was $884,460, when the correct amounts were $4,184,460 and $2,214,000, respectively.

According to the chief of Housing's Community Development Section, it used incorrect data to create the table. Despite the existence of a quality control process, Housing did not correct the errors before the report was published. Inaccurate financial data may lead report readers to incorrectly evaluate the cost of the CDBG program.

RECOMMENDATION

Housing should update its quality control processes to ensure that the financial data it reports are accurate.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with the finding. It says that it will strengthen its internal review process to better ensure the accuracy of all financial data included in the report. In addition, Housing states that it is developing an integrated financial and program information system for its federal programs. When implemented, this system will facilitate accurate, timely, and consistent reporting by providing a single source for financial information.

Reference Number:	2002-13-2
Federal Catalog Number:	14.239
Federal Program Title:	HOME Investment Partnerships Program
Federal Award Numbers and Calendar Years Awarded:	M97-SG 060100; 1997 M98-SG 060100; 1998 M99-SG 060100; 1999 M00-SG 060100; 2000 M01-SG 060100; 2001
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of the HOME Investment Partnerships program (HOME) identified the following compliance requirements related to subrecipient monitoring:

The Code of Federal Regulations, Title 24, Section 92.201(b), requires that the State review and audit its subrecipients as necessary or appropriate to determine whether the subrecipient has met program requirements. Section 85.12 specifies criteria for assigning a high-risk status to subrecipients and special restrictions the State may apply to future awards as a result of this status. Finally, Section 85.43 allows the State, among other actions, to withhold future awards from subrecipients who materially fail to comply with the terms of their agreement with the State.

CONDITION

Our review of Department of Housing and Community Development (Housing) subrecipient monitoring for fiscal year 2001-02 found that Housing does not adequately assess the need for monitoring and does not always report the results of its reviews.

Specifically, Housing has not completed assessments of many subrecipients that met its basic criteria for monitoring. In fiscal year 2001-02, Housing requested risk-assessment information from the 94 subrecipients who met its criteria for long-term monitoring of rental projects. Housing reviews this information to determine whether it needs to perform onsite-monitoring visits. As of November 2002, Housing had completed 30, or 32 percent, of the assessments. According to Housing, many subrecipients submit their assessments late or do not submit them at all. For example, Housing requested information from one subrecipient to assess whether a long-term monitoring visit was warranted. Despite repeated requests, the subrecipient failed to submit the information. After the last request, the subrecipient incorrectly stated that it was exempt from Housing's monitoring. Housing accepted the claim of exemption at the time without further research. Because of the low rate of compliance with its request for information, Housing has not completed its risk assessment for most of the subrecipients it identified as needing long-term monitoring and has consequently performed no monitoring of them.

Housing also did not report the final results of its monitoring visits to four additional subrecipients. Although Housing conducted the visits, it did not send the monitoring letters to formally notify the subrecipients of the results of the monitoring. Receipt of the monitoring letter represents the start of the 30-day period Housing allows its subrecipients to respond to any findings. As a result, these subrecipients did not know whether they should provide a written response to address any problems that Housing may have discovered during its visits.

RECOMMENDATIONS

Housing should clarify the steps it will take if subrecipients do not submit requested information. Specifically, subrecipients who fail to provide timely and adequate information could be categorized as high-risk and scheduled for monitoring visits. To encourage timely submission of requested information, Housing should also inform subrecipients of the enforcement actions it may take when subrecipients fail to comply. Finally, Housing should emphasize to its staff the importance of promptly reporting its monitoring results to subrecipients.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with the finding. Housing says that understaffing in the HOME program combined with increased federal HOME grant levels prevented it from completing its monitoring plans as scheduled during 2001-2002. It also says that it increased staffing in the HOME program by four positions in 2002-2003, directed staff to perform monitoring, and established a risk assessment tool to streamline the review process. However, due to further increases in federal grant and award levels (roughly 50 percent in the past two years) and a growing long-term management portfolio of rental projects, Housing was unable to meet its monitoring targets or conduct follow-up.

Housing says it will continue its efforts with existing staff and has proposed additional positions to create a monitoring team. In addition, Housing will strengthen its monitoring procedures and notify applicants found out of compliance with federal monitoring and reporting requirements that they will be subject to performance penalties in their next application for funding.

Reference Number:	2002-13-3
Federal Catalog Number:	14.239
Federal Program Title:	HOME Investment Partnerships Program
Federal Award Numbers and Calendar Years Awarded:	M97-SG 060100; 1997 M98-SG 060100; 1998 M99-SG 060100; 1999 M00-SG 060100; 2000 M01-SG 060100; 2001
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of federal programs identified the following requirements related to subrecipient monitoring:

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 nonfederal entities spending more than $300,000 in federal awards in a fiscal year have an annual audit conducted for that year and submit it within 30 days after receipt of the auditor's report or nine months after the end of the audit period, whichever is earlier. OMB Circular A-133 further stipulates that "pass-through" entities, such as the Department of Housing and Community Development (Housing), shall ensure that subrecipients spending $300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements for that fiscal year. In addition, it requires pass-through entities to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that a subrecipient takes appropriate and timely corrective action.

CONDITION

Housing does not have effective procedures to ensure that its nonprofit subrecipients meet audit requirements. Specifically, Housing did not pursue an audit or certification that the subrecipient was exempt because it did not meet the $300,000 threshold for six of 15 nonprofit subrecipients that had grant expenditures in fiscal year 2000-01. It failed to do so because it used grant award data for fiscal year 2000-01 rather than grant expenditure data to identify those subrecipients requiring audits. Because there is often a substantial lag between the time a grant is awarded and expended, the department's method can result in its requesting audits for the wrong time period. In addition, Housing did not receive audit reports or certificates of exemption for six of the nine remaining subrecipients from which it requested them. Housing sent request letters to the nonprofit subrecipients in February 2002. However, as of December 2002, Housing had made no further attempts to obtain documents from these six subrecipients nor had it imposed any sanctions on them. When Housing does not ensure that subrecipients meet audit requirements, it cannot ensure that they have complied with federal requirements and cannot follow up to assure that they have taken corrective action related to audit findings.

RECOMMENDATION

Housing should implement an effective system to ensure that all of its nonprofit subrecipients meet audit requirements.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with the finding. Housing says that the HOME and CDBG Annual Performance Reports will be modified to capture information related to compliance with OMB Circular A-133 before they are sent to subrecipients in June 2003. All current and prior HOME subrecipients will also be required to report if they have spent $300,000 or more in federal funds during the subrecipient's fiscal year and to certify that they have met the audit requirements for that fiscal year. Local governments that have spent $300,000 or more in federal funds will be directed to send their audits to the State Controller's Office. Nonprofit subrecipients that have spent more than $300,000 in federal funding will be directed to send their audits to Housing for review. Local governments and nonprofit organizations that have spent less than $300,000 in federal funds will be required to submit a certification to that effect.

Beginning with applications to be offered in April 2003, HOME and CDBG applications will also be modified to include a certification that the applicant is in compliance with OMB Circular A-133 at the time of application. Applicants found not to be in compliance with program requirements and who cannot resolve compliance issues will receive performance penalties.

Reference Number:	2002-13-6
Federal Catalog Number:	14.228
Federal Program Title:	Community Development Block Grant/State's Program
Federal Award Numbers and Calendar Years Awarded:	B-97-DC-06-0001; 1997 B-98-DC-06-0001; 1998 B-99-DC-06-0001; 1999 B-00-DC-06-0001; 2000
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of the Community Development Block Grant/State's Program (CDBG) identified the following compliance requirements:

The Code of Federal Regulations, Title 24, Section 570.492, requires the State to conduct reviews and audits of its subrecipients as may be necessary or appropriate to determine whether the subrecipient met program requirements.

CONDITION

The Department of Housing and Community Development (Housing) disclosed to us that in fiscal year 2001-02, it investigated one employee and disciplined another employee whom it says misinformed subrecipients of program requirements and, in some cases, falsified subrecipient monitoring documents. According to Housing, these staff carried about 60 percent of the caseload for the Economic Development sub-program. This sub-program amounted to 30 percent, or $13.3 million, of the program's total 2000-01 grant. Within days of the investigation and disciplining of these employees, they left Housing. Subsequently, Housing divided their caseload among other program staff. Housing said that it put emphasis on reviewing open grants to ensure that future expenditures were appropriate and met program requirements, but that it continued normal monitoring of other grants.

As of mid-February 2003, Housing has identified 22 noncompliant projects that were managed by its two former employees. For 12 of these projects, it has received about $544,000 in repayments from subrecipients and has issued demand letters requesting additional repayments totaling over $1.4 million. In addition, for eight of the projects, it has disencumbered about $1.5 million in awards that it never disbursed. Further for nine projects, Housing is considering issuing demand letters totaling up to $2.2 million if it cannot satisfy itself that the subrecipients have met program requirements. In order to understand the full extent of the problem, we asked Housing to detail the total number of projects that its two former employees had managed and the number of these that it subsequently monitored. Housing was not, however, able to provide us with a full accounting of the number or status of these projects.

RECOMMENDATIONS

Given the severity of the problems that Housing has identified in the projects overseen by its two former employees, it should fully account for the number and monitoring status of these projects, accelerate its review of projects that it has not yet monitored, and remonitor closed projects that have not yet passed their record retention date.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with this finding. It says it has identified the projects overseen by the two former employees. They consist of 156 grants, of which 78 are planning/technical assistance grants that do not require on-site monitoring. Housing states that the program is currently gathering information regarding the monitoring status of each grant. It anticipates having a complete report by mid-March 2003. Once the information is complete, the program will expedite the monitoring of grants that have

been closed out and that Housing's investigation revealed were not monitored, or were monitored by the former employees. Program staff will complete all required monitoring by June 2004.

Reference Number:	2002-14-2
Federal Catalog Number:	14.228
Federal Program Title:	Community Development Block Grant/State's Program
Federal Award Number and Calendar Year Awarded:	B-00-DC-06-0001; 2000
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Housing and Community Development

CRITERIA

Our review of the Community Development Block Grant/State's Program (CDBG) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 24, Section 58.22, prohibits a CDBG program recipient from committing funds on an activity or project until the State has approved the recipient's environmental certification. In addition, Section 58.18 says that states that elect to administer a U.S. Department of Housing and Urban Development program shall ensure that the program complies with the provisions for environmental review and must receive environmental certifications from recipients, accept objections from the public and other agencies, and perform other related responsibilities regarding releases of funds. The State CDBG Program Manual says that the Department of Housing and Community Development (Housing) will approve an environmental certification before releasing funds.

CONDITION

Housing is not ensuring that all its subrecipients submit environmental certifications before the subrecipients commit funds. When Housing does not ensure that environmental certifications are submitted before paying funds to subrecipients, it risks funding activities that are not eligible under the environmental review guidelines.

Two of the 40 subrecipients we tested, the cities of Corcoran and Mendota, requested and received funds from Housing in fiscal year 2001-02 without evidence that Housing had received the required environmental documents. Through December 31, 2002, Housing paid $109,000 and $482,000 to Corcoran and Mendota, respectively, without evidence of its having received these documents. Our testing of subrecipient monitoring also found that Housing released funds to another subrecipient without the subrecipient submitting the required environmental documentation. In this case, the city of Del Rey Oaks requested and received funds from Housing beginning in fiscal year 1998-99. As of December 31, 2002, Housing had paid $500,000 to this city, without having received the required environmental documents. As a follow-up to its monitoring of this subrecipient, Housing has requested that the city provide the required environmental documentation or return the funds it received.

RECOMMENDATION

Housing should ensure that it receives and approves environmental certifications before authorizing payments to subrecipients.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing agrees with the finding. It says that although its procedures and Cash Request Check Sheet clearly require that environmental review documentation be received and approved before funds are disbursed, in three instances copies of this documentation were not contained in the files. In two of the cases (Corcoran and Mendota), approved environmental documentation has now been received and placed in the file. In the third case (Del Rey Oaks), Housing had discovered the absence of environmental documentation during recent monitoring and is working with the city to determine the eligibility of the project.

Housing notes that these projects were among a number of projects assigned to a Housing employee who was found to have willfully failed to comply with departmental procedures and federal requirements. Housing states that it promptly initiated adverse action against the employee who then resigned. Housing also says that it began a thorough review of other grants assigned to the employee and has taken action to correct deficiencies in its records, evaluate project eligibility and where necessary, recover funds. Management has reminded staff of the importance of following procedures for reviewing environmental documentation and other special conditions before the release of funds. In addition, Housing says it has strengthened monitoring practices to deter future issues of this type and, should they occur, identify them more quickly.

U.S. DEPARTMENT OF JUSTICE

Reference Number:	2002-2-4
Federal Catalog Number:	16.606
Federal Program Title:	State Criminal Alien Assistance Program
Federal Award Number and Calendar Year Awarded:	2002-AP-BX-0074; 2002
Category of Finding:	Allowable Costs
State Administering Department:	Department of Corrections

CRITERIA

Our review of the State Criminal Alien Assistance Program (program) identified the following requirements related to allowable costs:

The application for program assistance requires the State to provide information for a prescribed reporting period. This period includes specific inmate population data and salary information for all full- and part-time permanent and contracted correctional officers. A program official with the U.S. Department of Justice clarified that correctional officers include facility staff whose primary function is the custody, control, and supervision of persons detained or incarcerated and may not include staff whose primary function is to provide generalized or specialized services to detainees or inmates. He also stated that the salaries of staff who function independently or outside of the facililty, including parole and probation agents and hearing officers, may not be included in the salaries reported on the application for assistance.

CONDITION

The Department of Corrections (Corrections) did not include only allowable salary costs in its federal fiscal year 2002 application for assistance. Specifically, of the total 28,064 correctional officers reported, Corrections included 75 revocation parole agents (parole agents) and one community correctional executive staff member with salaries totaling $5.2 million. However, these parole agents' primary job duties include specialized services to inmates, and they do not have the custody and supervision of inmates as a primary function. According to Corrections, rather than having an assigned caseload, these parole agents are assigned to the revocation function and assist in returning parolees to prison. For example, these parole agents may serve as district-hearing agents and testify in administrative hearings and judicial proceedings. These parole agents also work outside the prison facility either in a field office, regional, or headquarters setting. In addition, Corrections reported the salary of

one executive staff member of a community correctional facility. However, the executive staff member works outside of the facility and does not supervise inmates. According to Corrections' job description for this position, this executive staff member provides expertise in the administrative, custodial development, and planning for the expansion of community correctional facilities. For 75 percent of the time, for instance, this executive staff member performs administrative oversight functions; plans for the expansion of the community correctional facility program; and develops, recommends, and oversees the implementation of statewide policies for the program's administration.

The federal government uses the information in the State's application for assistance to calculate the State's percentage of available funds. Thus, when the State includes costs that are not allowable in its application, it causes the resulting percentage to be overstated. The submission of inaccurate data could jeopardize current and future program funding. The U.S. Department of Justice estimates that as a result of including these salaries, the federal government overpaid the State $478,795.

RECOMMENDATION

Corrections should ensure that it includes only allowable salaries in its application for assistance under the program.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Corrections included revocation parole agents' salary costs in the State Criminal Alien Assistance Program (SCAAP) application for several reasons: (1) These parole agents are peace officers that have direct and frequent interaction with the inmate population. Indeed, many of these agents are assigned full-time to various jails and receptions centers; (2) These parole agents provide custody and control of parolees/inmates for hearing purposes, including the placement of restraints on the parolee and; (3) The submission of salary costs for these positions was telephonically approved by Bureau of Justice (BJA) staff and noted by Corrections for inclusion in the State's federal fiscal year 2000 SCAAP salary costs. The federal fiscal year 2000 SCAAP guidelines define allowable "correctional officer" salary costs as:

> *A correctional officer is full- and part-time permanent and contractual custody staff, deputies, and any dispatchers who spend significant time with inmates. This may not include clerical, educational, administrative, or other such facility staff. Salary information SHOULD NOT include benefits.*

In addition, for the purpose of the federal fiscal year 2002 SCAAP application the BJA provided the following as the definition of a "correctional officer":

> *A correctional officer is considered any full or part-time permanent and contractual custody staff, deputies and any dispatchers who have direct interaction with the inmate population. Administrative support and program staff must not be included.*

Correctional officers may include, <u>but are not limited to</u>, the following:

- *First-line correctional officers*
- *First-line supervisors (Correctional Sergeants)*
- *First-line managers (Correctional Lieutenants)*
- *Wardens (Chief Executive Officers)*

For the purposes of SCAAP, correctional officers do not include clerical, educational, commissary, administrative, medical, or other such facility staff.

Corrections' inclusion of the Career Executive Assignment position for the Community Correctional Facilities Administration (CCFA) was based on the peace officer status of the position and that the position has the full scope and responsibilities as a Warden (Chief Executive Officer), allowable according to BJA guidelines. Similar duties and responsibilities between the two positions include the supervision of inmates and correctional officer staff, administration of the inmate classification, investigation and disciplinary processes, and a leadership role in the CCFA budgetary process. This Career Executive position functions at headquarters because it oversees 16 separate facilities throughout the State.

For future SCAAP applications Corrections will closely review the allowable salary cost definitions and attempt to reconfirm with BJA staff that these positions continue to meet SCAAP eligibility guidelines.

U.S. DEPARTMENT OF LABOR

Reference Number: 2002-2-3

Category of Finding: Allowable Costs

State Administering Department: Employment Development Department

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

CRITERIA

Our review of federal programs at the Employment Development Department (EDD) determined that the following are among the compliance requirements for allowable costs and cost principles:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), Attachment A, Section C(1)(b), states for costs to be allowable under federal awards, they must be allocable to federal awards under the provisions of the circular. Also, Attachment A, Section C(3)(a), states that a cost is allocable to a particular cost objective (that is, a grant) if the goods or services involved are chargeable or can be assigned to said cost objective in accordance with the relative benefits achieved. In addition, Attachment B, Section 11.h(5)(e), states that budget estimates or other distribution percentages determined before the services are performed do not qualify as support for personal service charges to a federal grant but may be used in the interim if the system for establishing the estimates produces reasonable approximations of the activity actually performed.

Furthermore, these estimated costs should be compared with actual costs reflecting actual activity at least quarterly, and be adjusted if necessary. Finally, Attachment B, Section 11 (h)(1), states that charges to federal awards for salaries and wages will be based on payrolls documented according to generally accepted practice of the governmental unit and approved by a responsible official of the governmental unit. EDD's employee time reports include a signature block for the person approving an employee's time.

CONDITION

Although EDD has made improvements in its system for allocating expenditures, we found that it did not adjust allocations to reflect actual activity. Specifically, EDD allocated three of the 30 payroll expenditures we reviewed. For two of the allocated costs, EDD was unable to document that it later compared the allocated costs to actual costs based on actual activity and subsequently made necessary adjustments. For the third allocated cost, EDD explained that it adjusted the original allocation to

reflect the percentage of the work unit's budget provided by various programs. Because this adjustment was not based on the actual activity related to these programs, it did not meet the requirements of OMB Circular A-87.

Because EDD did not compare allocated payroll costs to actual costs, we could not determine whether EDD appropriately charged programs for costs associated with the three payroll transactions totaling $11,500. In addition, we were unable to determine the full impact of this issue because EDD did not provide us with the total amount of costs it allocated during fiscal year 2001-02.

We reported a similar finding in our audits for fiscal years 1998-99 through 2000-01. We note, however, that in fiscal year 2001-02 EDD established a system to document the basis for the allocation codes it uses to distribute some costs. In addition, EDD asserts that it has significantly reduced the number of allocation codes it uses. Our fiscal year 2001-02 testing indicates that EDD does in fact depend less on this method of cost distribution than in fiscal year 2000-01.

In addition, for four of 30 payroll expenditures we reviewed, the signature block for approval of the related employee time sheet was blank. When a time sheet is not reviewed and approved there is less assurance that reported time accurately reflects the work of employees.

RECOMMENDATIONS

When EDD allocates costs, it should ensure that it later adjusts cost allocations to reflect actual activity. EDD should also reiterate to its staff that employee time sheets must be signed by those reviewing and approving the time sheets.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

EDD considers the costs charged to allocation codes to be direct charges and therefore are actual. All costs are reviewed and if the costs charged do not reflect actual, an adjustment is made. The allocation code percentages are reviewed and revised when a business process change necessitates it.

EDD will reiterate its policy that all employee time sheets be reviewed and signed by those reviewing the time sheet.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We agree that EDD treats these costs as direct costs. However, because EDD's cost allocations are based on predetermined percentages, they do not necessarily reflect actual costs chargeable to the individual federal programs.

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-11518-01-55; 2001

Federal Catalog Number:	17.801
Federal Program Title:	Disabled Veterans' Outreach Program
Federal Award Number and Calendar Year Awarded:	E-9-5-2-5085; 2001

Federal Catalog Number:	17.804
Federal Program Title:	Local Veterans' Employment Representative Program
Federal Award Number and Calendar Year Awarded:	E-9-5-2-5085; 2001

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Number and Calendar Year Awarded:	UI109240055; 2000

Federal Catalog Number:	17.258
Federal Program Title:	Workforce Investment Act (WIA) Adult Programs
Federal Award Number and Calendar Year Awarded:	AA-11240-00-50; 2001

Federal Catalog Number:	17.259
Federal Program Title:	WIA Youth Activities
Federal Award Number and Calendar Year Awarded:	AA-11240-00-50; 2001

Federal Catalog Number:	17.260
Federal Program Title:	WIA Dislocated Workers
Federal Award Number and Calendar Year Awarded:	AA-11240-00-50; 2001

Reference Number:	2002-3-11
Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-11518-01-55; 2001
Category of Finding:	Cash Management
State Administering Department:	Employment Development Department

CRITERIA

We determined that the following requirements relate to compliance with the Cash Management Improvement Act Agreement (CMIA agreement) between the U.S. Department of the Treasury and the State:

The CMIA agreement, Section 9.6, establishes requirements for calculating the State's interest liability. Section 9.6.2 provides the method for calculating this interest liability.

CONDITION

The Department of Finance (Finance) requires state departments to submit quarterly worksheets of federal cash receipts and disbursements. Finance uses the information on these worksheets to calculate the State's interest liability under the CMIA agreement. However, during fiscal year 2001-02 the Employment Development Department (EDD) submitted incomplete quarterly worksheets for the Employment Service grant. This happened because EDD reported only the transactions related to the employment services allotment—one of several allotments—making up the grant. For the entire fiscal year, the department reported only $76.8 million of the $83.8 million it actually received under the grant. The department stated that its quarterly worksheets included expenditures only for the employment-services allotment. The completeness of the cash receipt and expenditure data in the quarterly CMIA reports is critical to Finance's accurate calculation of federal and state interest liabilities for the required annual report. Because of the high volume of transactions, it was not feasible to determine the effect of EDD's incomplete reporting on the State's interest liability.

RECOMMENDATION

EDD should ensure that the quarterly worksheets it submits to Finance reflect complete information about the cash draws and expenditures for all allotments under the Employment Service grant.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The specific recommendation is moot; allotments under the Employment Service grant are no longer reportable due to an increase in the reporting threshold for CMIA, and were not included in the 2002-2003 Treasury-State Agreement. The department has, however, closely examined its reporting practices under the grants (Unemployment Insurance and Workforce Investment Act) which are still reportable to ensure that all relevant expenditures and drawdowns are included.

U.S. DEPARTMENT OF TRANSPORTATION

Reference Number:	2002-9-2
Federal Catalog Number:	20.205
Federal Program Title:	Highway Planning and Construction
Federal Award Number and Calendar Year Awarded:	N4520.162; 2001
Category of Finding:	Suspension and Debarment, Special Tests and Provisions
State Administering Department:	Department of Transportation

CRITERIA

Our review of the Highway Planning and Construction program identified the following compliance requirement:

The Code of Federal Regulations, Title 49, Section 18.42, in part, requires the State to retain all financial and program records, supporting documents, statistical records, and other records and documents considered pertinent to program regulations or the grant agreement for a three-year period. This period starts on the day the grantee, which is the State, submits its final expenditure report to the U.S. Department of Transportation, Federal Highway Administration (FHWA).

CONDITION

The California Department of Transportation (Caltrans) could not always locate its contract files or other documents to show that it complied with certain federal requirements for its highway construction projects. Specifically, of the 40 construction contracts that we tested that were active during fiscal year 2001-02, Caltrans could not locate the proposal and contract for one. As a result, we could not test whether Caltrans obtained the required suspension and debarment certification from this contractor. Although we identified similar records-retention errors during our audit for fiscal year 2000-01, we noted a marked decrease in exceptions in the sample in fiscal year 2001-02. In addition, we could not ensure that two of Caltrans' district offices performed quality-assurance testing on materials and workmanship it used for two of 12 construction projects we tested, because the offices could not locate the supporting documents or had prematurely purged the project files. As a result, we cannot conclude that Caltrans fulfilled its responsibilities related to these compliance

requirements. Furthermore, when Caltrans does not properly maintain documents that demonstrate its compliance with federal requirements for highway construction projects, it risks incurring costs that FHWA may not reimburse.

RECOMMENDATIONS

Caltrans should remind its staff to ensure the accuracy of its system of tracking contract files and other documents for its highway construction projects as well as ensuring that the contract files are retained for the length of time required by federal regulations. To ensure that the records retention-period is started from the correct date, Caltrans should provide records-retention staff with the date on which it submitted final expenditure reports for individual projects.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Caltrans says that it will remind staff of the importance of accuracy in tracking contract files and in providing proper retention time. In addition, Caltrans states that it will ensure that the final voucher date is provided to the filing staff to establish the beginning of the retention period.

U.S. ENVIRONMENTAL PROTECTION AGENCY

Reference Number:	2002-2-5
Federal Catalog Number:	66.468
Federal Program Title:	Capitalization Grants for Drinking Water State Revolving Fund
Federal Award Numbers and Calendar Years Awarded:	FS989124-01-0; 1997 FS989349-99-0; 1998
Category of Finding:	Allowable Costs/Cost Principles
State Administering Department:	Department of Health Services

CRITERIA

Review of the Capitalization Grants for Drinking Water State Revolving Fund (Fund) identified the following requirement relating to cost principles:

OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments,* establishes principles that are designed to provide that federal awards bear their fair share of the cost of administering federal programs. The Circular allows for direct costs for employee compensation, including fringe benefits, to be charged to the federal award if the time spent by the employee is specifically identified.

CONDITION

The Fund has approximately 140 employees on average that work on projects related to the capitalization grants. As many of these employees divide their time between Fund activities and activities of funds outside of the Fund, there is a need to allocate employees time among the appropriate funds. In order to accomplish this task, the Fund utilizes a time management system called Time Accounting System (TAS). Employee's allocated time is entered into TAS from time sheets maintained. The information accumulated in TAS is downloaded into the State of California's State Controller's Office for payroll processing and posting to CALSTARS. CALSTARS is the State of California's accounting and financial software. In order for proper posting to CALSTARS, each employee's position code in TAS must agree to the position number in the State Controller's Office database. Testing revealed instances of disagreement between the position codes in CALSTARS and TAS. As a result, the time that these particular employees spent during the month working on various funds may not be recorded appropriately in CALSTARS. Environmental Protection Agency

reimbursements from the capitalization grants received are based on the salary allocations posted to CALSTARS. A sample revealed that inappropriate recording resulted in a project undercharge to the federal program of approximately $28,000.

RECOMMENDATION

The differences in position numbers are attributable to changes made in an employee's position number not being communicated to the appropriate parties involved with processing payroll. The Fund should implement a policy regarding notification of differences in position numbers between the State Controller's Office and TAS in order to reduce the errors made in posting to CALSTARS.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Fund has made steps in mitigating these position number discrepancies as follows: 1) they are working with the Division Personnel unit to more closely track position numbers and changes; 2) the timing of the reports submitted to the Financial Management Branch will be changed to allow feed-back from the Financial Management Branch regarding any position number discrepancies; 3) any discrepancies noted in the position numbers will be researched and, if necessary, changes will be made to reflect agreement with the State Controller's Office position numbers; and 4) when the CALSTARS reports are posted to the web site, the information will be downloaded and compared with TAS and adjustments will be made accordingly.

Reference Number:	2002-3-14
Federal Catalog Number:	66.468
Federal Program Title:	Capitalization Grants for Drinking Water State Revolving Fund
Federal Award Numbers and Calendar Years Awarded:	FS989124-01-0; 1997 FS989349-99-0; 1998
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services

CRITERIA

Review of the Capitalization Grants for Drinking Water State Revolving Fund (Fund) identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 31, Part 205, provides the cash management requirements for federal grant programs. Subpart B of Part 205 pertains to those federal grant programs not covered by the Cash Management Improvement Act agreement between the State and the U.S. Department of the Treasury. This subpart requires the State to limit its cash advances from the U.S. Department of the Treasury to the minimum amounts necessary to meet immediate cash needs. It also requires that the timing of transfers be as close as administratively feasible to the State's actual cash outlay.

CONDITION

The Fund's accounting transactions are managed by the Department of Health Services, Financial Management Branch and the State of California's State Controller's Office. The Department of Health Services, Financial Management Branch submits a payment request to the State Controller's Office for invoices due. The State Controller's Office then processes the request and issues the warrants. The Financial Management Branch is also responsible for submitting a draw request to the Environmental Protection Agency (EPA) to draw down on the capitalization grants. Testing revealed that from the date that the draws were received from the EPA on the capitalization grants to the date the warrants were released from the State Controller's Office was excessive.

RECOMMENDATIONS

The Financial Management Branch should continue to reduce the timing between the submission of EPA draw requests and the disbursement request submitted to the State Controller's Office. Because the timing issue attributable to the State Controller's Office is not under the control of the Fund, the Fund should discuss this issue with the State Controller's Office and discuss possible resolutions within their office.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Fund agrees with the finding and will work with the Financial Management Branch and the State Controller's Office to reduce the time between EPA draw dates and warrant issue dates.

Reference Number:	2002-3-15
Federal Catalog Number:	66.468
Federal Program Title:	Capitalization Grants for Drinking Water State Revolving Fund
Federal Award Numbers and Calendar Years Awarded:	FS989124-01-0; 1997 FS989349-99-0; 1998
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services

CRITERIA

Review of the Capitalization Grants for Drinking Water State Revolving Fund (Fund) identified the following requirement relating to cash management:

The Environmental Protection Agency's *Audit Guide for Clean Water and Drinking Water State Revolving Fund Programs*, revised September 2002, outlines the timing of disbursements to subrecipients for loans. The Fund is to reimburse loan recipients after a request has been received for costs incurred, including pre-construction and construction related costs.

CONDITION

For many construction projects, an entity will contract with a construction company to perform work. To insure the entity's satisfaction with the work performed by the construction company, they often withhold 5% to 10% of each invoice (retainage) submitted by the construction company until the project is complete. At the end of the construction project, once all parties are satisfied as to the completion and quality of the work performed, the retainage is released and paid to the construction company. The Fund is currently reimbursing costs associated with retainage to local entities which have not yet paid out the retainage on the project, i.e., the local entity has not paid the contractor the retainage. When reviewing the requests for reimbursement, it was noted that the local governments submitted requests for reimbursement for construction work completed including retainages. The Fund has paid these retainages to the local government, which resulted in paying expenses before payment was due, although the work had been performed. This is a timing issue related to cash management of the program and therefore no questioned costs are associated with the finding.

RECOMMENDATION

The Fund should not disburse the retainage to the local entities until after final inspection and the final payment of retainage is made by the entity.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Fund agrees with the finding and recommendation and will train personnel processing the loan disbursements to local entities regarding this matter.

Reference Number:	2002-9-3
Federal Catalog Number:	66.458
Federal Program Title:	Capitalization Grants for State Revolving Funds
Federal Award Numbers and Calendar Years Awarded:	CS060001-98-0; 1998 CS060001-99-0; 1999 CS-06000100-0; 2000
Category of Finding:	Suspension and Debarment
State Administering Department:	State Water Resources Control Board

CRITERIA

Our review of the Capitalization Grants for State Revolving Funds (State Revolving Fund) program identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 40, Section 32.225, prohibits the State from knowingly doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. Further, Section 32.510 requires the State to obtain certifications from participating organizations regarding suspension and debarment.

CONDITION

The State Water Resources Control Board (Water Resources Board) did not obtain the required suspension and debarment certifications from its subrecipients during fiscal year 2001-02. Specifically, it did not obtain certifications from any of the

subrecipients that received federal funds from the State Revolving Fund program. The Water Resources Board provided subrecipients nearly $100 million in federal funding during fiscal year 2001-02. When the Water Resources Board does not obtain the required certifications, it risks allowing suspended or debarred parties to participate in the federal program. For the transactions we reviewed, we used an alternative test to determine that these program participants were not suspended or debarred.

RECOMMENDATION

The Water Resources Board should ensure that it obtains suspension and debarment certifications from all subrecipients of federal program funds.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Water Resources Board is aware of the requirement to secure suspension and debarment certificates from subrecipients receiving federal funds under the State Revolving Fund program. While it typically requires subrecipients to indicate they comply with federal law pertaining to suspensions and disbarments, it acknowledges that it does not have signed certifications with the language noted in the Code of Federal Regulations, Title 40, Part 32, Appendix A (Appendix A).

To assure compliance with this requirement, the Water Resources Board will obtain a signed certification with the specific language stated in Appendix A from all future subrecipients. This certification will be maintained in its files for future audit purposes. Alternatively, the Water Resources Board may include the specific language referenced in Appendix A in all future contracts with subrecipients and will require them to certify to those requirements. Further, the Water Resources Board will make all reasonable efforts to assure that existing subrecipients have supplied the required certifications.

Reference Number:	2002-12-4
Federal Catalog Number:	66.458
Federal Program Title:	Capitalization Grants for State Revolving Funds
Federal Award Number and Calendar Year Awarded:	CS-06000100-0; 2000
Category of Finding:	Reporting
State Administering Department:	State Water Resources Control Board

CRITERIA

Our review of the Capitalization Grants for State Revolving Funds (State Revolving Fund) program identified the following compliance requirements related to reporting:

The Code of Federal Regulations, Title 40, Section 31.20, requires the State to maintain accounting records to properly track and accurately report financial activities related to federal grants. Title 40, Section 35.3165, also requires the State to submit an annual report to the U.S. Environmental Protection Agency. This report contains a variety of financial data, including expenditure and loan repayment amounts.

CONDITION

In its annual report for fiscal year 2000-01, the State Water Resources Control Board (Water Resources Board) included expenditure information that was not supported by its accounting records and misstated other amounts. The Water Resources Board stated in its annual report that it spent a total of $308.5 million for the State Revolving Fund program: $97.5 million in federal money, $16.1 million in state money, and $194.8 million in State Revolving Fund money. However, the Water Resources Board's accounting records show that it actually spent a total of $312.5 million: $133.1 million in federal money, $24.1 million in state money, and $155.3 million in State Revolving Fund money. Rather than relying on its accounting records as the source of the financial information, the Water Resources Board relied on a database maintained by program staff. Further, the Water Resources Board did not reconcile the information from the database to its accounting records. The U.S. Environmental Protection Agency reported a similar issue to the Water Resources Board in an audit report it issued in 2002. In addition, for activity related to fiscal year 2000-01, the Water Resources Board overstated the amount available for loans by $521.3 million and overstated total loan payments and encumbrances by $405,000 because it did not correctly add together other figures it reported.

RECOMMENDATION

The Water Resources Board should ensure that it submits information in its annual reports that is accurate, complete, and supported by the accounting records.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

As noted in the finding, the U.S. Environmental Protection Agency audit of the State Revolving Fund found that the fiscal year 2000-01 annual report prepared by the Water Resources Board did not reconcile to its accounting records. As a result of this audit finding, staff members of the Water Resources Board have been working very hard to correct this reconciliation concern. The Water Resources Board expects the

reconciliation for fiscal year 2001-02 will be complete in the near future. It is confident that the fiscal year 2001-02 report and all future annual reports will reconcile with its accounting records.

FEDERAL EMERGENCY MANAGEMENT AGENCY

Reference Number: 2002-12-2

Category of Finding: Reporting

State Administering Department: Office of Emergency Services

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

CRITERIA

Our review of the Public Assistance Grants and Hazard Mitigation Grant programs determined that the following compliance requirement relates to reporting:

The Code of Federal Regulations, Title 44, Section 13.20, requires the State to maintain accounting records to properly track and accurately report financial activities related to federal grants.

CONDITION

In fiscal year 2001-02, the Office of Emergency Services (Emergency Services) did not reconcile the receipts and disbursements reported in its federal cash transaction reports to its official accounting records. As a result, we could not determine whether the receipts and disbursements reported in the quarterly federal cash transaction reports agreed with Emergency Services' accounting records.

RECOMMENDATION

Emergency Services should reconcile the receipts and disbursements reported in its federal cash transaction reports to the receipts and disbursements recorded in its accounting records.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Given the current budget situation and ongoing workloads, Emergency Services will be unable to request additional positions to augment the existing accounting office staff. However, Emergency Services will initiate a review of the skills needed to accomplish the reconciliation task and seek to redirect existing staff within the agency to assist the accounting office in resolving this finding.

FEDERAL EMERGENCY MANAGEMENT AGENCY

Federal Catalog Number:	83.544
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2001-02

Federal Catalog Number:	83.548
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2001-02

Reference Number:	2002-12-3
Category of Finding:	Reporting
State Administering Department:	Office of Emergency Services

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

CRITERIA

Our review of the Public Assistance Grants and Hazard Mitigation Grant programs determined that the following compliance requirements relate to reporting:

The Code of Federal Regulations, Title 44, Section 13.20, requires the State to maintain accounting records to properly track and accurately report financial activities related to federal grants. Additionally, Section 13.41(b) requires the State to use the financial status report form to report the status of funds for all nonconstruction grants. To meet this requirement, the Federal Emergency Management Agency (FEMA) requires the Office of Emergency Services (Emergency Services) to submit quarterly financial status reports for each disaster. FEMA mandates that the status reports are to include total recipient and subrecipient non-federal expenditures, and administrative expenses.

CONDITION

Emergency Services' financial status reports do not contain complete and accurate expenditure information. For each of the five financial status reports for fiscal year 2001-02 that we tested, Emergency Services did not report recipient share of outlays

for the Hazard Mitigation Grant program because it does not have a process in place to compile the expenditure information it receives from subrecipients. In addition, Emergency Services did not provide separate disclosure of its and the subrecipients' administrative costs in the financial status reports for the Public Assistance and Hazard Mitigation grant programs. FEMA requires separate reporting of administrative expenditures so that it can accurately compute and analyze the shared costs of a disaster.

RECOMMENDATIONS

Emergency Services should establish a process to compile the recipient share of outlays it receives and accurately report these expenditures. It should also separately account for and report its and the subrecipients' administrative costs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services has made several attempts over the years to discuss with FEMA how best to report California disaster activity (which currently involve more than 23,000 individual projects) into a single, generic federal report format. Given the repeat nature of this finding, however, Emergency Services will initiate a formal request to FEMA management this year to reach a consensus on how to report on-going disaster assistance activity without creating a burdensome workload for the State.

FEDERAL EMERGENCY MANAGEMENT AGENCY

Federal Catalog Number:	83.544
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2001-02

Federal Catalog Number:	83.548
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2001-02

Reference Number: 2002-13-1

Category of Finding: Subrecipient Monitoring

State Administering Department: Office of Emergency Services

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

CRITERIA

Our review of the Public Assistance Grants and Hazard Mitigation Grant programs determined that the following compliance requirements relate to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires subrecipients spending more than $300,000 in federal assistance to submit audit reports to the State within nine months of the end of their fiscal year. If an audit finds that a subrecipient has failed to comply with federal program requirements, OMB Circular A-133 also requires the State to issue a management decision regarding the resolution of the audit finding within six months of receiving the audit report and ensure that the subrecipient proceeds with corrective action as rapidly as possible.

CONDITION

During fiscal year 2001-02, for the audit reports of its local government subrecipients, the Office of Emergency Services (Emergency Services) did not ensure that a management decision regarding the resolution of audit findings was made within six months after it received an audit report. During fiscal year 2001-02, the State Controller's Office reviewed the annual audit reports of local governmental agencies receiving more than $300,000 and forwarded two reports to Emergency Services, one of which contained three unresolved findings. Emergency Services received a corrective action plan for this report. However, it did not issue a written management decision that clearly states whether the audit findings were sustained, the reasons for its decisions, and actions it expected the auditee to take to resolve the audit findings.

RECOMMENDATIONS

Emergency Services should promptly follow up on all reported audit findings concerning subrecipients, and ensure that written management decisions regarding the resolution of audit findings are issued within six months of its receipt of the subrecipients' audit report.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

While the Bureau of State Audits is correct in noting that Emergency Services did not issue a written management decision on one of the single audit reports within six months of its receipt, Emergency Services did receive and process 240 single and program audit reports during fiscal year 2001-02. In light of the Bureau of State Audits' finding, however, Emergency Services will revisit its current review procedures to ensure that all management decisions are issued in a timely manner.

FEDERAL EMERGENCY MANAGEMENT AGENCY

Federal Catalog Number:	83.544
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2001-02

Federal Catalog Number:	83.548
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2001-02

U.S. DEPARTMENT OF EDUCATION

Reference Number: 2002-1-1

Category of Finding: Activities Allowed

State Administering Department: Department of Education

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

CRITERIA

Our review of the Special Education—Grants to States program (Special Education) and Special Education—Preschool Grants program identified the following requirements relating to activities allowed:

The United States Code, Title 20, Section 1413(a)(1), requires that each local educational agency (LEA) have policies, procedures, and programs that are consistent with state policies and procedures. In addition, California Education Code, Section 56205, requires that each special education local plan area include these policies, procedures, and programs in its local plan. Further, Section 56131 requires that funds be apportioned according to an approved local plan.

CONDITION

The Department of Education (Education) did not ensure that it disbursed Special Education and Special Education—Preschool Grants funds for allowable purposes. Of the 40 subrecipient files we reviewed, Education paid two subrecipients $1.3 million during fiscal year 2001-02 even though the subrecipients did not have an approved local plan for the period. Although we found no evidence that Education paid the subrecipients for unallowable activities, Education risks doing so if it disburses funds to subrecipients without an approved local plan and without a copy of the local plan in Education's files for verification of allowable activities.

RECOMMENDATION

Before it disburses funds, Education should ensure that each subrecipient of its Special Education and Preschool Grants programs has an approved local plan in Education's files for verification of allowable activities and costs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education has implemented a process that ensures the local plan is approved before funds are disbursed.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A000116; 2000 H027A010116; 2001

Federal Catalog Number:	84.173
Federal Program Title:	Special Education—Preschool Grants
Federal Award Number and Calendar Year Awarded:	H173A010120; 2001

Reference Number:	2002-2-1
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—Basic State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A000005; 2001
Category of Finding:	Allowable Costs and Cost Principles
State Administering Department:	Department of Education

CRITERIA

Our review of Migrant Education—Basic State Grant Program (Migrant Education) identified the following requirements related to allowable costs and cost principles:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments* (OMB Circular A-87), Attachment A, Section C,

states that for costs to be allowable under a federal award, costs must be necessary and reasonable for the proper and efficient performance and administration of federal awards.

CONDITION

The Department of Education (Education) did not always determine the cost-effectiveness of the State's use of Migrant Education funds. Education authorized one subrecipient to enter into and administer a contract that Education should more appropriately administer. Specifically, Education allocates Migrant Education funds to 22 migrant education regional offices statewide. In addition, because the U.S. Department of Education requires Education to report the number of migrant children in California eligible for the program, the 22 regional offices enter data regarding eligible migrant children into a computer system.

The data are transmitted to a vendor that combines the data from all the regional offices, ensures that migrant children are not counted more than once, and calculates the number of eligible migrant children in California. Although Education administers the contract with this vendor, Education authorized one regional office to administer a contract with another vendor that provides software and technical assistance to the statewide regional offices for the development and entry of their count data. The vendor services appear to be an appropriate use of Migrant Education funds. However, Education should more appropriately administer this contract because it is for assisting the regional offices statewide, and not just for the one regional office. Consequently, the contract authorized almost $34,000 in overhead costs to the one region for its administration of the contract, which may not be necessary for the proper and efficient performance and administration of the program. During 2002, Education entered into a contract with the second vendor. The contract's initial period of performance was from January 1, 2002, through December 31, 2002. However, the Department of General Services approved the contract on August 29, 2002. Education has proposed to extend the contract through June 30, 2003.

RECOMMENDATIONS

Education should continue to take on the contract-administration responsibilities for the software and technical assistance contract. In addition, Education should ensure that it approves only allowable costs that are reasonable and necessary to perform the program.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education is awaiting the Department of General Services' approval to extend the contract with the vendor for software and technical assistance through June 30, 2003. Beginning with fiscal year 2003-04, Education will continue the contract administration responsibilities with this vendor on a state fiscal year contract period.

Reference Number:	2002-3-1
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A010005; 2000 H126A020005; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) identified the following compliance requirements related to cash management:

The Code of Federal Regulations, Title 31, Section 205.7(b), requires the State to minimize the time between the transfer of funds from the U.S. Treasury (Treasury) and the disbursement of these funds for program purposes. Additionally, Section 205.9 allows the State to enter into a Treasury-State agreement for implementing this requirement. This agreement states that when the Department of Rehabilitation (Rehabilitation) issues payments to vendors for the Vocational Rehabilitation program, it will use the "pre-issuance" funding technique. When using the pre-issuance technique, state agencies will make every effort to request federal funds so they are deposited in a state account no more than two business days before the day the State makes a disbursement. The agreement also recognizes that because of variances in processing time, the two-day deposit requirement will be met for the majority, but not all, of the fund requests.

In addition, the agreement states that for its payroll and operating expenses, Rehabilitation may use either the pre-issuance technique described above or the "after-cost allocation" technique. When using the after-cost allocation technique, state agencies will make payments for program purposes with state funds and request federal funds after the actual costs are allocated to the programs or funding sources.

Finally, the Code of Federal Regulations, Title 31, Section 205.17, states that the federal government may deny payment or credit for any federal interest liability resulting from the State's failure to request funds according to the funding technique set forth in the agreement.

CONDITION

Rehabilitation does not have an adequate control process for cash management of the Vocational Rehabilitation program. As a result, it did not consistently use the appropriate funding techniques.

During fiscal year 2001-02 Rehabilitation did not always use the pre-issuance funding technique for paying vendors and did not always correctly use this technique for other vendor payments and certain payroll disbursements. Specifically, for 2,741 (50 percent) of the 5,468 warrants issued for vendor payments under the Vocational Rehabilitation program, Rehabilitation did not use the pre-issuance technique, but rather, requested federal funds after the State Controller's Office issued the warrants. In addition, when Rehabilitation used the pre-issuance technique, it did not always follow the procedure described in the Treasury-State Agreement. Specifically, Rehabilitation held the federal funds for more than two calendar days for 972 (18 percent) of the 5,468 warrants issued for vendor payments and for three of the 12 payroll disbursements for the year. Rehabilitation correctly used the pre-issuance technique for only 1,755 (32 percent) of the warrants issued for vendor payments under the Vocational Rehabilitation program. The longer the State holds federal funds, the greater the State's interest liability to the federal government.

For the remaining nine payroll disbursements for the year, Rehabilitation used the after-cost allocation technique. Although the Treasury-State Agreement does not require that federal funds be drawn within a specific number of days from the date of disbursement, the Treasury-State Agreement exists to help ensure that neither the federal government nor the State benefits or suffers financially because of any transfer of funds. Therefore, the State should still be minimizing the time between the disbursement for a federal program and the draw of federal funds. We found, however, that Rehabilitation did not always request federal funds to reimburse the State within a reasonable time. Specifically, for these nine payroll disbursements Rehabilitation took longer than six days to request federal funds, and for three of these disbursements, Rehabilitation took from 22 to 24 days to request the federal funds. For the vendor payments we tested and all of its payroll draws, Rehabilitation has correctly reported the days from when federal funds are deposited in the State account and the funds are disbursed. The Department of Finance has used the data provided by Rehabilitation in its calculation of interest liability. However, when Rehabilitation does not consistently use the appropriate agreed-upon funding techniques, the federal government may not pay its resulting liability.

RECOMMENDATIONS

Rehabilitation needs to implement procedures for the Vocational Rehabilitation program to ensure it uses the appropriate funding techniques and uses them correctly. Also, Rehabilitation should seek to minimize the time between the expenditures made and the draw of federal funds. If Rehabilitation determines that the agreed-upon funding techniques are no longer appropriate, it should request a change to the Treasury-State Agreement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Rehabilitation agrees with this recommendation and implemented new procedures in October 2002 to ensure that the appropriate funding techniques are used. Rehabilitation started using a special cash management-handling request to the State Controller's Office, thereby minimizing the time between the warrant issue date and the draw of federal funds.

Reference Number:	2002-3-2
Category of Finding:	Cash Management
State Administering Department:	California Community Colleges, Chancellor's Office

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

CRITERIA

Our review of federal programs identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows subrecipients to receive advance payments provided they demonstrate the ability to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, if subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between the receipt and disbursement of federal funds.

CONDITION

The California Community Colleges, Chancellor's Office (Chancellor's Office) does not have adequate procedures to ensure that subrecipients of the Vocational Education—Basic Grants to States program (Vocational Education) and the Tech-Prep Education program (Tech-Prep) minimize the time elapsing between their receipt and use of federal program funds. Under its payment procedures, the Chancellor's Office approves program advances for each subrecipient and disburses these advances each month based on predetermined percentages. However, because the Chancellor's Office approves advances that exceed some subrecipients' immediate cash needs, some subrecipients carry excessive cash balances during the fiscal year.

The Chancellor's Office approves subrecipient applications, calculates advances, and pays these advances in monthly installments. To determine if a

subrecipient's spending approximates the advances, the Chancellor's Office uses the subrecipients' quarterly year-to-date expenditure reports to compare the reported expenditures to the amounts it advanced to each subrecipient. If it determines that a subrecipient's spending approximates the advances, the Chancellor's Office authorizes further advance payments in full; otherwise, it reduces the subrecipient's monthly advance payments. Further, when the Chancellor's Office determines that a reduction in the monthly advance payment amount is warranted, generally it begins making these adjustments in the third quarter of the fiscal year. For fiscal year 2001-02, the Chancellor's Office adjusted its advance calculations for the Vocational Education and Tech-Prep programs. For the Vocational Education program's initial advance, the Chancellor's Office based the calculation on prior-year spending and certified subrecipients to receive specific percentages of their tentative grant award. The Chancellor's Office made adjustments to its other advance calculations for the Vocational Education and Tech-Prep programs. In both instances, the Chancellor's Office certified subrecipients to receive specific percentages of their grant award based on their rate of spending through the first and third quarters, respectively.

Although the Chancellor's Office made adjustments to its advance calculations, our review still found that a significant number of subrecipients of the Vocational Education and Tech-Prep programs maintained high cash balances during the first and second quarters of fiscal year 2001-02. For example, 25 of the 30 subrecipients we reviewed for the Vocational Education program maintained high cash balances ranging from $7,837 to $193,715 during the first quarter. By the third quarter, four of the 30 subrecipients maintained high cash balances ranging from $15,317 to $116,293. We considered balances high when they exceeded 10 percent of the amounts advanced by the Chancellor's Office. Similarly, for the Tech-Prep program, during the second quarter 15 of the 20 subrecipients we reviewed maintained high cash balances ranging from $9,315 to $75,820. During the third quarter, two of the 20 subrecipients we reviewed maintained high cash balances of $14,161 and $22,098. Because the Tech-Prep program subgrants are small, we considered balances high when they exceeded $7,000 and 10 percent of the amounts advanced for this program.

The Chancellor's Office is responsible for ensuring that subrecipients minimize the time between the subrecipients' receipt and use of federal funds. When the Chancellor's Office does not adequately assess its subrecipients' immediate cash needs before approving monthly advances, it cannot assure that subrecipients minimize the time elapsing between the receipt and use of federal funds.

RECOMMENDATION

To minimize the time elapsing between the receipt and use of federal program funds, the Chancellor's Office should reassess the amount disbursed through the advance process and approve initial advances that more closely reflect each subrecipient's immediate cash needs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Apportionment is the primary method the Chancellor's Office uses to transfer Vocational and Technical Education (VTEA) funds to colleges. Apportionment is formula driven. Once the allocation is approved, it is released in monthly installments at a rate intended to approximate spending. The first opportunity to adjust monthly installments occurs in January. The second is late spring. Cash on hand occurs when a subrecipient's monthly installments outpace their expenditures.

Cash on hand has been an ongoing audit concern. In the 1999-2000 program year, subrecipients' monthly payments were based on their total allocation. Subrecipients were slow to implement program plans. Payments in the first and second quarters exceeded expenditures. In 2000-2001 monthly payments were based on 70 percent to 80 percent of the annual allocation. Payments in the first and second quarters exceeded expenditures. Once again subrecipients did not spend as fast as they had expected they would. In 2001-2002 the monthly installments were based on 66 percent to 83 percent of the annual allocation to more closely approximate expenditures. Cash on hand was again identified as a problem. Aggressive measures have since been taken to correct the situation. For 2002-2003, each subrecipient's previous year's spending patterns were closely evaluated. Allocations and monthly installments were set at an amount that matched the previous year's expenditure reports. First and second quarter expenditures have been closely reviewed. A new analysis tool developed by VTEA staff helps provide quick assessment of spending patterns so automatic adjustments can be made at first and second apportionment.

Three other factors have contributed to the cash on hand situation including 1) slow approval of annual spending plans, 2) confusion about the apportionment process, and 3) State budget cuts. The Chancellor's Office has taken steps to address each of these situations:

1. Plan approval—It has been reported that local business offices will not allow spending until an approved signed plan has been signed and returned. The Chancellor's Office has taken steps to insure that plans are processed quickly, and that subrecipients are notified of approval so program implementation and spending may begin as soon as possible after July 1.
2. Apportionment process—The apportionment process is complex. Limited understanding of the certified versus allocated amount has slowed spending. Vocational Education Services Team (VEST) Memo 02-048, dated June 24, 2002, provided an overview of the process and explained the monthly installments process.
3. State budget cuts—The State's uncertain budget situation has undermined subrecipients' spending confidence. Proposed funding cuts to categoricals have been generalized to include VTEA. Some subrecipients have not differentiated between federal, state, restricted and categorical funds. The lack of understanding has resulted in restrictions on spending. VEST Memo 03-02, dated January 29, 2003, addressed the issue.

As with VTEA, the Chancellor's Office continues to refine its Tech-Prep allocation procedures to address cash on hand. Aggressive steps have been taken during the 2002-2003 program year. Quarterly reports are more closely monitored, and apportionments are adjusted at the first and second period as needed. In this fiscal year, carry over augmentations have been delayed until subrecipients have demonstrated timely expenditure reporting. Augmented funds being placed into the apportionment process include small hold back amounts to assist the system's overall cash management. The Chancellor's Office released an advisory memo that outlined the allocation and expenditure process to assist subrecipeints with timely program implementation and reporting of expenditures.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A010005; 2001

Federal Catalog Number:	84.243
Federal Program Title:	Tech-Prep Education
Federal Award Number and Calendar Year Awarded:	V243A010005; 2001

Reference Number:	2002-3-4
Federal Catalog Number:	84.186
Federal Program Title:	Safe and Drug-Free Schools and Communities—State Grants
Federal Award Number and Calendar Year Awarded:	S186B010005; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Alcohol and Drug Programs

CRITERIA

Our review of the Safe and Drug-Free Schools and Communities—State Grants (Safe and Drug-Free Schools) program identified the following compliance requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a State's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a State's subrecipients to promptly pay to the federal agency any interest greater than $100 per year that they earned on the advances. Additionally, if a State's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between the receipt and disbursement of federal funds.

CONDITION

The Department of Alcohol and Drug Programs (DADP) lacks adequate procedures to ensure that subrecipients of the Safe and Drug-Free Schools program minimize the time elapsing between receipt and use of program funds.

DADP awards subgrants to counties to carry out the program's activities. In accordance with state law, DADP makes monthly subgrant payments to counties regardless of their actual expenditures. DADP also does not require the counties to submit invoices to support the monthly payments. Although DADP is instituting procedures to track county expenditures quarterly to better assess each county's cash needs, it had not yet fully implemented these procedures during fiscal year 2001-02. As a result, DADP cannot be sure that counties minimize the time between the counties' receipt and use of federal funds throughout the year.

Additionally, although DADP's agreements with the counties require them to remit interest in excess of $100 earned on federal program advances, DADP continues to not require counties to report that interest. As a result, DADP does not know if any counties earned interest greater than $100 on federal program advances and whether counties should be remitting interest earnings to it.

According to DADP, effective July 1, 2002, it implemented new cash management procedures for the Safe and Drug-Free Schools program due to the implementation of the No Child Left Behind Act of 2001. Under the new cash management procedures, DADP plans to use a competitive grant process and reimburse subrecipients quarterly.

RECOMMENDATIONS

DADP should ensure that the counties participating in the program minimize the time elapsing between their receipt and use of federal program funds. DADP should also require the counties to report and pay DADP any interest earnings greater than $100 on these advances so it can repay these earnings to the federal award agency.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

As noted supra, on July 1, 2002, DADP implemented new cash management procedures. Under the new cash management procedures, competitive grants will be awarded and subrecipients will be reimbursed quarterly.

Reference Number:	2002-3-6
Category of Finding:	Cash Management
State Administering Department:	Department of Education

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

CRITERIA

Our review of the Special Education—Grants to States program (Special Education) and Special Education—Preschool Grants program identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows subrecipients to receive advance payments provided they demonstrate the ability to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires subrecipients to promptly pay to the federal agency any interest greater than $100 per year that they earned on the advances. Additionally, if subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between the receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the elapsed time between their receipt and use of federal program funds. Under its payment procedures, Education disburses predetermined percentages of program funds to

subrecipients rather than assess each subrecipient's immediate cash needs and disburse funds accordingly. For example, for the grant period from August 2001 through September 2002, Education disbursed to Special Education subrecipients 25 percent of their grant awards in January 2002, March 2002, and June 2002, respectively. After it receives the subrecipients' final expenditure reports, which are due 60 days after the end of the grant period, Education disburses any remaining amounts owed. Although the timing of the disbursements appears reasonable, Education does not require subrecipients to report their expenditures before disbursing the second and third payments. Thus, it has no assurance that subrecipients minimize the time between their receipt and disbursement of federal program funds.

Of the 40 transactions we reviewed for the Special Education and Special Education—Preschool Grants programs, 29 were advance payments for the 2000 and 2001 grant awards. The cumulative grant award total for the subrecipients represented in the 29 transactions was $58.8 million. Because 75 percent of the Special Education and Special Education—Preschool Grants program funds were disbursed to subrecipients before Education received information on the subrecipients' use of funds, $44.1 million was disbursed with no assurance that these subrecipients minimized the time between the receipt and use of federal funds.

Additionally, Education did not require subrecipients to report and remit interest in excess of $100 earned on these federal program advances. As a result, these subrecipients may use the interest earned on federal program advances for activities that may not be allowable.

RECOMMENDATIONS

To minimize the elapsed time between the receipt and use of federal program funds, Education should implement procedures to assess each subrecipient's cash needs and adjust its advance payments accordingly. Additionally, Education should ensure its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Education should also establish controls for reporting earnings greater than $100 on these advances so it can repay these interest earnings to the federal awarding agency. Finally, if Education determines it cannot implement procedures to ensure the subrecipients report program expenditures in time for it to assess cash needs and make additional payments, it should consider procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education does not agree with the wording that payments are made in "advance." In actuality, the first payment made to the subrecipients occurs at least three months after the program year has begun. Of our 17 grant award programs covered under Special Education and Special Education—Preschool Grants, we have less than a

one percent billing at the end of the program year to recoup excess payments. To include an interim report between the first and second payment would necessitate an additional workload that is not warranted.

For fiscal year 2002-03, Special Education and Special Education—Preschool Grants program added to all expenditure reports specific language indicating that interest earned over $100 should be promptly remitted to the federal agency.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Education asserts that it does not make advance payments in this program because it sends the first payment at least three months after the beginning of the program year. However, without obtaining interim expenditure information, it cannot be certain that the amounts sent do not exceed its subrecipients' immediate cash needs for the program. In addition, Education's assertion that it has few excess payments to recoup at the end of the program year does not address its responsibility under the cash management requirement to insure that its subrecipients minimize the time between their receipt and use of federal funds throughout the year.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A000116; 2000 H027A010116; 2001

Federal Catalog Number:	84.173
Federal Program Title:	Special Education—Preschool Grants
Federal Award Number and Calendar Year Awarded:	H173A010120; 2001

Reference Number:	2002-3-9
Category of Finding:	Cash Management
State Administering Department:	Department of Education

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

CRITERIA

Our review of federal programs identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a state's subrecipients to promptly pay to the federal agency any interest greater than $100 per year that they earned on the advances. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between the receipt and disbursement of federal funds. Moreover, sections 299.1 and 299.2 state that the regulations in Section 80 apply, with some exceptions, to titles I through XIII of the Elementary and Secondary Education Act.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not require its subrecipients to report on their use of program advances before making additional payments to them. Combining Education's lack of procedures to assess each subrecipient's cash needs with its predetermined advance-payment process does not ensure that subrecipients minimize the time elapsing between their receipt and disbursement of federal program funds.

Of the 60 expenditure transactions we reviewed for 40 Title I Grants to Local Educational Agencies (Title I, Part A) subgrant awards, 39 were payments to 25 participating school districts and 21 were payments to 15 participating schools. We divided our sample equally among the first, second, and third apportionments. Because Education disbursed all of these Title I, Part A funds before it received information on the subrecipients' use of funds, at least $107 million was disbursed with no assurance that subrecipients minimize the time elapsing between the receipt and use of federal funds.

Additionally, for 34 of the 35 subrecipients we reviewed for the Title VI—Innovative Education Program Strategies (Title VI) program, Education disbursed 100 percent of the funds without receiving information on the subrecipients' use of funds. As a result, Education disbursed at least $709,000 with no assurance that subrecipients minimize the time elapsing between the receipt and use of federal funds. Moreover, our review found that Education awarded and disbursed to the same subrecipients $671,000 for fiscal year 2000-01. However, 23 of the 34 subrecipients carried over $364,000

(54 percent) from fiscal year 2000-01 to fiscal year 2001-02. The amounts that these 23 subrecipients carried over ranged from $122 to $115,584. The percentages of amounts the 23 subrecipients carried over ranged from 3 percent to 183 percent of the amounts Education disbursed in previous fiscal years.

Finally, Education did not require subrecipients to report and remit interest in excess of $100 per year earned on these federal program advances. As a result, these subrecipients may use the interest earned on federal program advances for activities that may not be allowable.

RECOMMENDATIONS

To minimize the time elapsing between the receipt and use of federal program funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect each of its subrecipients' immediate cash needs. Additionally, Education should ensure its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Education should also establish controls for reporting earnings greater than $100 on these advances so it can repay these interest earnings to the federal awarding agency. Finally, if Education determines it cannot implement procedures to ensure the subrecipients report program expenditures before it assesses cash needs and makes additional payments, it should consider implementing procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Effective with the 2003-04 fiscal year, Education will obtain documentation from each local educational agency (LEA) to ensure minimal time elapses between disbursement of funds and use of funds. When determining the type of documentation, consideration will be given to local and state resources. Documentation may include a summary or detailed expenditure report, or LEA certification of expenditures prior to subsequent apportionments. If Education cannot fully implement this process by the 2003-04 fiscal year end, Education will explore other payment options.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A010005; 2001

Federal Catalog Number:	84.298
Federal Program Title:	Title VI—Innovative Education Program Strategies
Federal Award Number and Calendar Year Awarded:	S298A010005; 2001

Reference Number:	2002-3-10
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—Basic State Grant Program
Federal Award Numbers and Calendar Years Awarded:	S011A000005; 2000 S011A010005; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Migrant Education—Basic State Grant Program (Migrant Education) identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time elapsing between the receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a state's subrecipients to promptly pay to the federal agency any interest greater than $100 per year that they earned on the advances. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between the receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Migrant Education subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds. Under its

payment procedures, Education disburses program funds to subrecipients based on predetermined limits rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not always require its subrecipients to report on their use of current-year program advances before making additional payments to them. Combining Education's inadequate procedures to assess each subrecipient's cash needs with its predetermined advance-payment process does not ensure that subrecipients minimize the time elapsing between their receipt and disbursement of federal program funds.

Of the 40 expenditure transactions we reviewed for the Migrant Education program, 34 were payments to 18 of Migrant Education's 22 regional offices. For the fiscal year 2001-02 grant award, we compared Education's first advance payment to these regional offices against their mid-year expenditure reports, and found that eight had high-ending balances ranging from $2,381 to $1,120,436. We considered any positive balance high because Education disbursed the first advance payment, approximately 40 percent of the sub-award, by November 2001. This was at least three months before the end of the six-month period for which the regional offices reported expenditures. In addition, for the fiscal year 2000-01 grant award, we compared other advance payments to seven of the regional offices against the regions' most recent expenditure reports. We found that for one of the regional offices, its expenditures did not approximate its advances.

When Education does not assess its subrecipients' immediate cash needs before making federal program advances, it cannot assure that subrecipients minimize the time elapsing between the receipt and use of federal funds.

Finally, Education did not require subrecipients to report and remit interest in excess of $100 earned on these federal program advances. As a result, these subrecipients may use the interest earned on federal program advances for activities that may not be allowable. However, beginning in fiscal year 2002-03, Education is requiring subrecipients of the Migrant Education program to report interest earned in excess of $100 as part of the expenditure report process.

RECOMMENDATIONS

To minimize the time elapsing between the receipt and use of federal program funds, Education should implement procedures to assess each subrecipient's cash needs and adjust its advance payments to more closely reflect each of its subrecipients' immediate cash needs. Additionally, Education should ensure its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Education should also ensure the implementation of controls for reporting earnings greater than $100 on these advances so it can repay these interest earnings to the federal awarding agency. Finally, if Education cannot demonstrate its ability to ensure subrecipients minimize the time elapsing between the receipt and disbursement of federal program advances, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Effective with the 2003-04 fiscal year, Education will reduce the cash advance payment to Migrant Education regions to 30 percent. Before the subsequent payment is issued, Migrant Education will review the region's expenditure report to assess the expenditures made with the cash advance. If there is a significant discrepancy between the advance and the documented expenditures, Migrant Education will contact the region to discuss the discrepancy. Based on the information received from the region, Migrant Education will take the appropriate action, with the possibility of reducing the subsequent payment.

Migrant Education added an additional reporting field to the expenditure report requesting the subrecipient report the amount of interest earned over $100. Migrant Education also included verbage from the Code of Federal Regulations, Title 34, Section 80.21, regarding submission of interest earned over $100, in its Migrant Education Fiscal Requirements handbook.

Reference Number:	2002-5-1
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A010005; 2000 H126A020005; 2001
Category of Finding:	Eligibility
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) determined that the following are among the compliance requirements for eligibility:

The Code of Federal Regulations, Title 34, Section 361.42, requires the State to conduct an assessment of an applicant's eligibility and priority for program services. This section further requires the State to base the applicant's eligibility only on a determination that:

- The individual has a physical or mental impairment.
- The impairment substantially impedes employment.

- A presumption that the individual can benefit from program services.
- The individual requires program services to prepare for, secure, retain, or regain employment.

Additionally, Section 361.41 requires the State to determine an individual's eligibility for program services within 60 days of receiving his or her application, with certain exceptions.

CONDITION

The Department of Rehabilitation (Rehabilitation) does not always determine applicant eligibility for the Vocational Rehabilitation program within the required time period. Of the 35,345 applications received by the department between July 1, 2001, and April 30, 2002, Rehabilitation did not determine eligibility, obtain an extension, or close cases within the 60-day deadline for 7,342 cases (21 percent). In 4,796 of the 35,345 applications (14 percent), Rehabilitation determined an applicant's eligibility after 60 days or obtained an agreed-upon extension after the deadline.

Of the cases for which Rehabilitation determined eligibility, Rehabilitation was fewer than 10 days late in 47 percent of the cases, between 11 and 30 days late in another 29 percent of the cases, and between 31 and 60 days late in an additional 15 percent of the cases. Rehabilitation took more than 60 additional days after the required 60 days to determine eligibility in 9 percent of the cases. Rehabilitation had not determined eligibility status in 800 cases as of July 31, 2002, and 1,746 cases had other resolutions after the 60-day deadline. When Rehabilitation does not determine applicants' eligibility within the required time period, it reduces the assurance that clients receive the required rehabilitative services promptly.

RECOMMENDATIONS

To make sure applicants receive program services promptly, Rehabilitation should determine eligibility within the required time period. Rehabilitation should emphasize to district coordinators, supervisors, and counselors that they should identify and prioritize cases that are close to exceeding the 60-day deadline. Currently available reports, such as the "Reminder/Approval List," are valuable tools in determining eligibility or the need for an extension within the 60-day deadline.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Rehabilitation agrees with this finding and has implemented the following corrective action plan.

Rehabilitation states that it will continue to take proactive steps through a collaborative effort with district administrators, rehabilitation supervisors, and counselors to ensure timely and appropriate eligibility determinations. Below is Rehabilitation's summary of

its previous and ongoing actions related to improving timely eligibility determinations. According to Rehabilitation, these actions will be ongoing until satisfactory compliance is achieved.

Action #1—Share information with district administrators

Through regional district administrators' meetings, best practices for timely eligibility determinations are being identified and shared. The district administrators are now receiving reports that track the number of overdue eligibility determinations for each counselor on a monthly basis. These reports are distributed to rehabilitation supervisors and counselors for prompt and immediate follow-up.

Action #2—Inform and educate rehabilitation staff

The importance of timely eligibility determination continues to be stressed in all department-sponsored training courses and during staff meetings. The Case Recording Handbook, Chapter 2, also provides a full description of the presumptive eligibility provisions in the Code of Federal Regulations. Counselors and rehabilitation supervisors continue to receive automated reminder notices on the Field Computer System before the expiration of the 60 days allowed for eligibility determination.

Action #3—Local level monitoring of eligibility determinations

The rehabilitation supervisors continue to conduct reviews of eligibility determinations and extensions to ensure appropriateness and compliance with federal regulations. Rehabilitation supervisors work with the counselors to utilize existing information to the maximum extent possible and the presumptive eligibility criteria to ensure more timely eligibility determinations. Counselors and rehabilitation supervisors continue to receive automated reminder notices on the "Reminder/Approval Lists" before the expiration of the 60 days allowed for eligibility determination. In addition to the automated reminder notices, reports are generated monthly to track the number of overdue eligibility determinations in each district. These reports are shared with the district administrators and rehabilitation supervisors for review and follow-up. These reports have been modified to include information as to whether the consumer receives Supplemental Security Income or Social Security Disability Income to ensure that presumptive eligibility criteria is being applied in a manner consistent with the Rehabilitation Act to expedite the eligibility determination process for consumers.

Action #4—Executive level monitoring of eligibility determinations

On a monthly basis, Employment Preparation Services regional administrators prepare regional and district summary reports for each deputy director. The deputy directors review these overdue eligibility reports and the Consumer Satisfaction Surveys to identify trends of overdue eligibility determinations and then work with the district administrators to resolve the issues preventing the timely determination of eligibility. The district administrators are asked to review these reports and report back to the deputy directors with corrective plans to address any overdue eligibility determination issues.

Action #5—Provide guidance and monitoring to cooperative program partners

Rehabilitation contract administrators continue to collaborate with their cooperative program partners to ensure the timely processing and eligibility determination of program applicants. Annual cooperative contract renewal training has occurred over the past three years. The most recent training was held in October/November of 2002 and was provided to each of the districts with the participation of their partner agency contract administrators. This training supports the requirement that the referral and application process for all cooperative programs be delineated in each contract. Additionally, an Interagency Agreement between Rehabilitation and the California Department of Education specifically addressing the legal parameters and procedures in making student referrals to Rehabilitation was developed and signed on November 7, 2000. Rehabilitation developed five regional trainings in spring 2001 that provided district administrators and local education administrators statewide the operational procedures used to identify qualified students for referral, guidelines in securing parental written consent, sharing and use of evaluations and assessments, and application and eligibility criterion. Similar training has been provided to select counselors and supervisors at the request of district administrators. Rehabilitation contract administrators and education contract administrators are also provided with a list of consumers, on a monthly basis, who are in application status and coded to each cooperative program. Both agencies use this list as an additional tool to ensure that program applicants referred to Rehabilitation have had their applications processed in a timely manner.

Reference Number:	2002-7-1
Federal Catalog Number:	84.298
Federal Program Title:	Title VI—Innovative Education Program Strategies
Federal Award Number and Calendar Year Awarded:	S298A990005; 1999
Category of Finding:	Earmarking
State Administering Department:	Department of Education

CRITERIA

Our review of the Title VI—Innovative Education Program Strategies (Title VI) program identified the following requirements relating to earmarking:

The United States Code, Title 20, Section 7331(b), requires that no more than 25 percent of funds available for state programs be used for administration. Additionally, Section 8821 allows the State to consolidate administrative funds of several programs, including the Title VI program.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that it meets the Title VI program earmarking requirements. Thus, it cannot assure that it spent federal funds in compliance with federal regulations. Education consolidates its state administration funds for Title VI and several other federal programs. Using the funds from each program, it determines the proportionate share for each program and applies those proportions to the costs it incurs. For the Title VI program, Education consolidated the entire $6.1 million available for state use and spent these funds for administration and other state-level activities, such as technical assistance and statewide education reform. However, it should have consolidated only $1.5 million (25 percent) of the funds set aside for state use and should have restricted administrative expenditures to this consolidated pool. It should have tracked separately the remaining $4.6 million for other state-level activities. As a result, the Title VI program may have borne a disproportionate share of the state administration costs incurred.

Education has asserted that the U.S. Department of Education (USDE) should have been aware it consolidated as administrative funds most of the allocation for state operations in the Title VI program. In 1996, Education applied for and received a waiver from the USDE to consolidate administrative funds for several programs. In the information Education provided to USDE, it reflected that it intended to consolidate as administrative funds for the Title VI program most of its allocation set aside for state use. In the same document, Education indicated that it would spend the consolidated funds not just on administration but on other activities including technical assistance and statewide education reform. Nevertheless, the USDE determined in February 2003 that Education should have consolidated as administrative funds no more than 25 percent of the amount allocated for state use.

RECOMMENDATION

Education should ensure that it consolidates for state administration only 25 percent of the funds set aside for its use to meet the Title VI earmarking requirement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education agrees that it did consolidate the entire amount available for state use under the Title VI program and used these funds for administration and other state level activities, such as technical assistance and statewide education reform.

Education addressed the consolidation of administration costs, not only in the waiver, but also in the Consolidated State Plan. With the approval of these documents, Education believes it had the authority to consolidate the entire amount; and therefore, operated in good faith.

Education is unable to impose additional expenditure controls several years after the expenditures have occurred. However, it will review its files and records of expenditures to determine if there is any documentation reflecting the amount spent on Title VI administration versus other activities. With the passage of the No Child Left Behind Act, the opportunity for consolidation of costs has been eliminated. Consequently, Education is no longer consolidating administrative funds, and this should not be an issue in the future.

Reference Number:	2002-7-2
Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A010005; 2001
Category of Finding:	Level of Effort
State Administering Department:	Department of Education

CRITERIA

Our review of the Vocational Education—Basic Grants to States program (Vocational Education) identified the following requirements related to level of effort:

The United States Code, Title 20, Section 2413(a), requires the State to provide from nonfederal sources for state administration of Vocational Education programs an amount that is not less than the amount provided by the State from nonfederal sources for state administrative costs for the preceding fiscal year.

CONDITION

The Department of Education (Education) did not ensure that it met its level of effort requirement for administration of the Vocational Education program for fiscal year 2001-02. Specifically, Education does not have a sufficient process to ensure that it identifies all administrative expenditures from nonfederal sources for the Vocational Education program. Beginning with fiscal year 2000-01, Education revised its process

to exclusively use regional occupational center program (regional occupational center) administration expenditures to determine compliance with the level of effort requirement. However, the process excludes other Vocational Education administration expenditures from both Education and the California Community Colleges, Chancellor's Office (Chancellor's Office), which are provided by the State from nonfederal sources. In May 2002, the U.S. Department of Education issued a report questioning Education's inclusion of the regional occupational center administrative expenditures as well as its exclusion of Chancellor's Office administrative expenditures.

In addition, Education did not follow its own process for determining whether it met the level of effort requirement. Although Education identified approximately $16 million in regional occupational center administration expenditures for fiscal year 2000-01, it did not include all of these expenditures in its level of effort calculation. Instead, Education included just $3 million for fiscal year 2000-01 and estimated expenditures of $2.1 million for fiscal year 2001-02, indicating that it has a $900,000 shortfall in its administrative level of effort. Because fiscal year 2001-02 data for the regional occupational centers was not available when our fieldwork ended, we could not compare this data to the $16 million in expenditures to ensure that Education met the level of effort requirements. When Education does not meet its administrative level of effort, it may receive a reduced grant award in future years.

RECOMMENDATION

Education should implement a process to ensure that it properly calculates its administrative level of effort. In doing so, Education should include amounts provided by the State from all nonfederal sources for administration expenditures, including those provided by Education and the Chancellor's Office.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education will immediately begin implementing a process to properly calculate the Vocational Education match level of effort. The Vocational Education match will include all amounts recorded by Education, the Chancellor's Office, and the regional occupational centers as Vocational Education administration match expenditures.

The 2001-02 Vocational Education administration match expenditures will be accurately reported to the U.S. Department of Education on the final Financial Status Report.

Reference Number:	2002-9-1
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A010005; 2000 H126A020005; 2001
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) determined that the following are among the compliance requirements for suspension and debarment:

The Code of Federal Regulations, Title 34, Section 80.35, prohibits the State from knowingly doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. In addition, Title 34, Section 85.510, mandates the State to require certifications from participating organizations affirming they are not suspended, debarred, ineligible, or voluntarily excluded from transactions by any federal agency. Further, Section 85.110 makes procurement contracts for goods or services expected to equal or exceed $100,000 subject to the suspension and debarment certification requirements.

CONDITION

The Department of Rehabilitation (Rehabilitation) did not obtain the required suspension and debarment certifications from any of the five contractors we reviewed. Rehabilitation awarded these participants of the Vocational Rehabilitation program procurement contracts of $100,000 or more. The five contracts we reviewed totaled more than $1.5 million. Without obtaining the required certifications, Rehabilitation risks unknowingly allowing suspended or debarred parties to participate in the Vocational Rehabilitation program. For the transactions we reviewed, we used an alternative test to determine that these participants were not suspended or debarred.

RECOMMENDATION

Rehabilitation should ensure that Vocational Rehabilitation participants receiving procurement contracts of $100,000 or more submit the required suspension and debarment certification before Rehabilitation approves their participation in the Vocational Rehabilitation program.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Rehabilitation agrees with the finding and is in the process of reviewing the federal regulations to determine the contracts that are impacted and to develop the procedures to implement the recommendation to ensure suspension and debarment certifications are received prior to the awarding of procurement contracts in the Vocational Rehabilitation program.

Reference Number:	2002-9-6
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Education

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

CRITERIA

Our review of federal programs identified the following requirements relating to suspension and debarment:

The Code of Federal Regulations, Title 34, Section 85.225, prohibits the State from knowingly doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. Further, Section 85.510 mandates the State to require a certification from organizations submitting proposals certifying that neither the organization nor its principals are presently debarred, suspended, proposed for debarment, declared ineligible, or voluntarily excluded from participation in federal assistance programs by a federal agency.

CONDITION

In fiscal year 2001-02, the Department of Education (Education) did not require local educational agencies (LEAs) applying to participate in the Title I Grants to Local Educational Agencies (Title I, Part A), Title VI—Innovative Education Program Strategies (Title VI), and Class Size Reduction programs to submit the required

suspension and debarment certifications. Instead, Education required LEAs to assure that they had complied with the certification requirement. Thus, although it requires LEAs to apply for program funding annually, Education cannot demonstrate that LEAs made the required certification before it approved their participation in the program.

When Education does not require participants in the Title I, Part A, Title VI, and the Class Size Reduction programs to submit the required certification when they apply for program funding, it risks unknowingly allowing suspended or debarred parties to participate in the federal programs. For the transactions we reviewed, we used an alternative test to determine that these program participants were not on the federal suspended or debarred list.

Beginning with the 2002-03 funding year application, Education revised the legal assurances to include the following, "The LEA assures that neither it, nor its principals is presently debarred, suspended, proposed for debarment, declared ineligible, or voluntarily excluded from participation by any Federal department or agency." Certification, by signature, of adherence to the legal assurances will meet the requirements of suspension and debarment.

RECOMMENDATION

Education should ensure use of the revised legal assurances as part of the annual consolidated application.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education is using the 2002-03 Consolidated Application which contains the revised legal assurances regarding suspension and debarment. The Superintendent or authorized representative for each LEA certifies to these assurances when the LEA submits Part I of the Consolidated Application.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A010005; 2001

Federal Catalog Number:	84.298
Federal Program Title:	Title VI—Innovative Education Program Strategies
Federal Award Number and Calendar Year Awarded:	S298A010005; 2001

Federal Catalog Number:	84.340
Federal Program Title:	Class Size Reduction
Federal Award Number and Calendar Year Awarded:	S340A010005; 2001

Reference Number:	2002-12-6
Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A010005; 2001
Category of Finding:	Reporting
State Administering Department:	Department of Education

CRITERIA

Our review of the Vocational Education—Basic Grants to States (Vocational Education) identified the following requirements related to performance reports:

The United States Code, Title 20, Section 2323(c), requires the State to prepare and submit an annual report containing data as to whether it met its adjusted performance levels for each of four core indicators of performance and other indicators.

CONDITION

The Department of Education (Education) did not report accurate, complete, and supported data in its Vocational Education performance accountability report. Specifically, at the time of our testing, because Education could not provide adequate support for the information in the report it submitted to the U.S. Department of Education (USDE) in December 2001, we were unable to verify the accuracy and completeness of the data for three of the four core indicators. Additionally, for the remaining core indicator, it used the same data as it used in its prior-year report. During our audit of fiscal year 2000-01, we found this data was either inaccurate or incomplete. Consequently, Education again reported unreliable information. Education disclosed that it used prior-year data in its report to the USDE. Nevertheless, when Education does not compile and report accurate and complete data, the USDE cannot accurately assess the State's performance in the Vocational Education program.

RECOMMENDATION

Education should implement procedures to ensure that the information in its Vocational Education performance report is supported, accurate, and complete.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education does not concur with the statement, "Education did not report accurate, complete, and supported data in its Vocational Education performance accountability report." For three of the four indicators on the December 2001 report, the Career Technical Education accountability data (accountability data) was accurate and complete, although difficult to verify. Education received the accountability data through three sources: directly from the districts electronically; directly from the districts via mail; and from a vendor who aggregated each school's accountability data and summarized it by district then forwarded the district information. These three sources accurately support the information provided in the December 2001 report.

Education was unable to provide the placement data on program completers required for Core Indicator #3 because it was not due from the local educational agencies (LEAs) until a month after the revised report deadline. Therefore, based on USDE's advice, Education reported the same placement data submitted on the 1999-2000 report. Both USDE and Education were aware that the placement data was inaccurate and incomplete.

The collection and reporting of all accountability data used for the report has been corrected. Beginning with the 2001-02 program year, Education implemented a single data system for importing and aggregating the accountability data provided in the LEAs' report.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Although Education asserts that the accountability data for three of the four core indicators was accurate and complete, it could not provide us with adequate support to ensure that the aggregated accountability data was correctly summarized by its vendor. Thus, we were unable to verify the accuracy and completeness of the data.

Reference Number:	2002-14-1
Federal Catalog Number:	84.032
Federal Program Title:	Federal Family Education Loans
Year Awarded:	State fiscal year 2001-02
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 to administer activities associated with the loan program. This section also requires the operations of the auxiliary organization to be conducted in conformity with an operating agreement approved annually by Student Aid and requires Student Aid to oversee the operations of the auxiliary organization.

CONDITION

Student Aid's auxiliary organization administers the loan program. However, the auxiliary organization has not developed adequate internal controls over its information systems to provide reasonable assurance that it keeps current, complete,

and accurate records of each loan. Specifically, we found weaknesses in the auxiliary organization's controls over entitywide security planning and management, and restriction of access to sensitive locations and to computer software and data files. We also found weaknesses in the operating agreement between Student Aid and its auxiliary organization. These weaknesses hamper Student Aid's ability to ensure that the auxiliary maintains strong controls over its information systems.

The auxiliary organization management has not provided sufficient entitywide security planning and management. We found that the auxiliary organization has neither performed a comprehensive security risk assessment nor developed an entitywide security program plan. This plan should clearly describe the auxiliary's security program and the policies and procedures that support it. In addition, the security program plan should cover all major facilities and systems and outline the duties of the security management function. The auxiliary organization has addressed the areas the security management function is responsible for, however, it has lessened its importance by not dedicating an individual to this function. Currently, this function is shared by two individuals whose primary responsibilities are to manage the auxiliary organization's computer operations support and the systems and network architecture. The lack of planning and management has led to insufficient protection of sensitive or critical computer resources.

The auxiliary organization does not have adequate physical security controls, which are the controls that limit access to sensitive areas and protect them from loss or impairment. We found that the auxiliary organization did not limit access to the computer operations facility to those employees who have a legitimate need for access to perform their job duties. Specifically, we identified 56 individuals who were allowed access to the computer operations facility although their job duties were not related to the maintenance or operation of the information system. Moreover, the layout of the computer operations facility can be strengthened. We noted that certain equipment and the tape library are centrally located within the computer operations facility instead of being in a separate secure area with limited access. Compounding these weaknesses is the fact that the auxiliary organization's computer operations staff run the computer operations facility from a remote location separate from the computer operations facility, which may allow individuals with access to the facility to have unmonitored access.

The auxiliary organization also needs to strengthen its logical security controls. Logical security controls are the policies and electronic access controls designed to restrict access to computer software and data files. The auxiliary organization has the following weaknesses in controls over its software and data files:

- It does not promptly remove employees' electronic access when they transfer or leave the employ of the auxiliary. We found that one employee retained his access privileges from one division for 12 months after he had transferred to another division. Two other former employees still had electronic access to critical data even though they had not been in the employ of the auxiliary for up to 31 months.

- It has given five employees from one division the ability to add, change, or delete information from student loan data and the information system's master files. This level of access can allow for inappropriate modification of sensitive loan data and system files.
- It has not developed preventive controls that would prohibit the 59 employees with a total of 172 guaranteed student loans from modifying or deleting their own borrower information. In addition, the auxiliary organization has not performed reviews that could promptly identify whether student loan data had been modified inappropriately.
- It allows a limited number of employees to make changes to sensitive data in an environment that is not subject to the normal edits of its information system. In addition, the auxiliary does not maintain a complete history or audit trail of data changes made for a sufficient period of time to allow for the audit of these changes. The logical access controls do not limit access on a "need-to-know" basis, which allows these employees to access data that is not related to their business function.

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. Currently, the operating agreement does 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. Moreover, the operating agreement does not include a requirement for the auxiliary organization to have an audit in conformity with the provisions of Statement on Auditing Standards Number 70 (SAS 70), "Service Organizations," which would report on controls placed in operation and results of tests of operating effectiveness. Such an audit would disclose whether the auditor believes the auxiliary organization's controls are suitably designed to achieve specified control objectives, whether they had been placed in operation as of a specific date, and whether the controls that were tested were operating with sufficient effectiveness to provide reasonable assurance that the related control objectives were achieved during the period specified.

RECOMMENDATIONS

Student Aid's auxiliary organization should implement an entitywide program for security planning and management that addresses the security management function and provides for strong physical and logical security controls over its information systems. This will ensure that it maintains current, complete, and accurate records for each loan that it holds. In addition, Student Aid should amend its operating agreement with its auxiliary organization to specify its expectations related to the control structure over the information system. Further, Student Aid should strongly consider adding the requirement that its auxiliary organization periodically have a SAS 70 review of its information systems.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Student Aid agrees with the recommendation above. With the advent of the Internet, the rapid increase of external system user interfaces, and the prospect of potential sabotage or fraud, security and risk management has become both more complicated and more crucial than ever before. Student Aid and its auxiliary organization have managed the operation of the core student loan management system, FAPS, for more than ten years. Security and risk management practices are continuously reviewed and upgraded.

The auxiliary organization has provided the following information that demonstrates its commitment to operating a secure system in order to maintain data integrity.

- The auxiliary organization examined and upgraded many of its system management policies and procedures when FAPS was moved from an outside data center to an internal data center in July 2001. The auxiliary organization continuously monitors and deters attempts by external parties seeking unauthorized access to the auxiliary organization's systems via the Internet. Additional work was completed last year to ensure business continuity following a project to upgrade system redundancy and remote restart capability in the event of a major disaster.

- For the most part, technology security and risk management has been the exclusive responsibility of the auxiliary organization's Technology and System Solutions Division. As the auxiliary organization strives to achieve an even greater level of integration both with external customers and within the company's special purpose systems, it will be necessary to expand the scope and character of risk management and information security to all of the auxiliary organization's divisions that are also responsible for the integrity of data and of systems. In addition, Student Aid will discuss with the auxiliary organization the need for an independent Information Security Officer.

Student Aid is pleased to observe that no actual breaches in security or violations of data integrity were noted in this report. While a system of the size and complexity of FAPS will always require an adequate workforce to manage and maintain it, it is appropriate to monitor who has access and for what purposes.

With that in mind, the auxiliary organization will take the following actions:

- update the security access of personnel who no longer require that access to perform their jobs.
- re-examine the most recent uses of data maintenance to determine if there is appropriate business justification for continuing special user access.
- evaluate the feasibility of designing new on-line screens that can replace data maintenance.

- revise policy safeguards to reduce risk to data integrity with respect to concerns about the auxiliary organization's staff that have student loans and access to FAPS.

Also, Student Aid will ensure that procedures are in place and followed.

Student Aid and its auxiliary organization will examine the provisions of Statement on Auditing Standards Number 70 (SAS 70) and determine whether they would be appropriate and warranted. Both Student Aid and the auxiliary organization are dedicated to ensuring the highest level of security and risk mitigation for technology programs. It makes good business sense to invest time and resources to ensure that the internal controls exist in order to keep Student Aid's records and program safe and secure. Student Aid, if appropriate, will consider requiring periodic SAS 70 reviews.

In addition to the general recommendation for an entity wide security program, the draft findings note several specific areas of concern. The auxiliary organization has provided the following information in response to those specific concerns:

- **Security management functions.** In performing a risk assessment and documenting the entity wide security plan, the management function will be considered and addressed.

- **Access to computer operations facility.** The auxiliary organization has reduced the number of staff that has card access to the computer room. Access will be examined periodically to ensure risk is mitigated by allowing access only to staff with business need, including building security, maintenance, and operations of information system.

- **Tape Library.** While the tape library is secure, it is not separately secured from the computer operations room. Because of the limited access to the computer room, this has not created any undue risk. However, the auxiliary organization will examine the feasibility of restricting access to the computer operations room.

- **Removal of electronic access.** This process has been reviewed and strengthened and will be more closely monitored in the future.

- **Divisional employees with system access.** The number of staff with this data maintenance capability has been examined and will be reduced if possible. This function is required to provide customer service to our lenders. To ensure proper controls, the keying function is separate from the decision-making function and appropriate documentation is maintained.

- **Employees with loans.** The auxiliary organization is revising its policy with respect to applicants or employees with student loans to mitigate the risk of inappropriate changes to FAPS. The revised policy will prohibit any employee from processing any changes to their own accounts. The auxiliary organization will institute a review process to audit employee accounts and review for any inappropriate account changes.

- **Table maintenance changes with insufficient audit trail.** The auxiliary organization's procedure for table maintenance is being modified and will require a before and after report to document the changes made that will be verified by the operational staff requesting the change.

Student Aid's Loan Program Oversight Division has the responsibility of ensuring the auxiliary organization is in compliance with the provisions of the Operating Agreement and will monitor the implementation of the activities mentioned above.

Reference Number: 2002-14-4

Category of Finding: Special Tests

State Administering Department: Department of Education

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

CRITERIA

Our review of the Migrant Education—Basic State Grant Program (Migrant Education) and the Title I Grants to Local Educational Agencies program (Title I, Part A) determined that the following compliance requirements relate to the comparability of school services:

The United States Code, Title 20, sections 6322(c) and 6394(c), require local educational agencies (LEAs) that receive Migrant Education and Title I, Part A funds to use state and local funds to provide school services that are at least comparable to services provided by schools not receiving these federal funds, unless otherwise excluded. Furthermore, these sections state that an LEA will have met the requirement of comparability if the LEA has filed with the state education agency a written assurance that the LEA has established and implemented an LEA-wide salary schedule; a policy to ensure equivalence among schools in teachers, administrators, and other staff; and a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies.

CONDITION

The Department of Education (Education) did not require LEAs receiving Migrant Education and Title I, Part A funds to file with Education a specific written assurance stating that the LEAs have established and implemented an LEA-wide salary schedule; a policy to ensure equivalence among schools in teachers, administrators, and other staff; and a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies. Instead, Education required each LEA

to agree to follow standard legal assurances for the respective programs. However, these assurances fall short of the written assurance specified by federal law.

The Migrant Education legal assurance specified for LEAs the comparability requirements, but did not require LEAs to submit a written assurance. The Title I, Part A legal assurance stated, "the LEA has developed and implemented procedures for compliance with the comparability requirements and the compliance documents are updated biannually." However, this assurance does not state that the LEA has actually established and implemented the specific policies and procedures that federal law requires to ensure comparable school services. In addition, although Education reviews local policies and procedures during its LEA site visits, it only reviews each LEA on a four-year cycle, and the review instrument it uses does not specify reviewing the policies and procedures to ensure comparable school services. Therefore, Education cannot be sure that LEAs have established and implemented the policies and procedures federal law requires to ensure comparable school services.

When Education does not require LEAs to assure to it in writing that they have implemented specific policies and procedures for using state and local funds to provide school services that are at least comparable to the services provided by schools not receiving Migrant Education and Title I, Part A funds, it cannot be sure that LEAs are using these federal program funds to provide educationally disadvantaged students the additional assistance they need to achieve academic success.

We reported similar findings in our audits of fiscal years 1998-99, 1999-2000, and 2000-01 for these programs. At the time, Education stated it would continue to work with the U.S. Department of Education (USDE) to determine the expectation for monitoring the comparability of school services. The USDE identified a similar finding for the Title I, Part A program in a 1998 Integrated Review report. Although Education previously stated that once the comparability issue was satisfactorily resolved for Title I, Part A, it would also be resolved for all Title I programs, including Migrant Education; it has not yet resolved this issue with the USDE. Nevertheless, beginning with the 2002-03 funding year application, Education revised the Title I, Part A legal assurances to include the following, "The LEA has established and implemented a district-wide salary schedule; has a policy to ensure equivalence among schools in teachers, administrators, and other staff; and has a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies." Certification, by signature, of adherence to the legal assurances should meet the requirements of comparability.

RECOMMENDATIONS

Education should ensure use of the revised legal assurances for the Title I, Part A program and alter the legal assurances for the Migrant Education program accordingly. Additionally, Education should continue to work with the USDE about how Education should revise its monitoring process to ensure that LEAs comply with the comparability requirement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

For the 2002-03 funding cycle, Education used the Consolidated Application that contains the revised legal assurances for the Title I, Part A program. Beginning with the 2003-04 program year, Education will revise the Migrant Education legal assurance language for comparability to:

> *An LEA has determined comparability on a district wide basis or on a grade span basis if the LEA files with the SEA a written assurance that it has established and implemented:*
>
> 1. *an LEA-wide salary schedule;*
> 2. *a policy to ensure equivalence among schools in teachers, administrators, and other staff; and*
> 3. *a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies.*

Education has contacted USDE regarding their expectation for monitoring the Title I, Part A comparability of school services, and received sample comparability determination documentation. Education will share this documentation with the State Controller's Office and work with them to incorporate an additional procedure specific to comparability into the state audit guide, which is used for the annual audit of the LEAs in California. This additional check will include an analysis of the pupil/teacher ratio among all schools operated by an LEA, as illustrated in the USDE's example.

Beginning with fiscal year 2001-02, Migrant Education incorporated in its fiscal review the examination of compliance with the comparability requirement by the school districts and schools in the region. Each region will be reviewed at least once every two years.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A010005; 2001

Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—Basic State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A010005; 2001

U.S. DEPARTMENT OF EDUCATION
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number: 2002-8-1

Category of Finding: Period of Availability

State Administering Department: Department of Alcohol and Drug Programs

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

CRITERIA

Our review of federal programs identified the following compliance requirements relating to period of availability:

The United States Code, Title 42, Section 300x-62, requires the State to obligate any Substance Abuse Prevention and Treatment Block Grant amounts by the end of the fiscal year in which the amounts are awarded; and if obligated, spend these amounts by the end of the next fiscal year.

Additionally, the Code of Federal Regulations, Title 34, Section 76.709(a), mandates that if the State does not obligate all of its Safe and Drug-Free Schools and Communities—State Grants (Safe and Drug-Free Schools) program funds by the end of the 15-month funding period for which they were appropriated, the State may obligate the remaining funds for one additional year. In addition, Section 80.23(b) requires the State to liquidate all obligations incurred under an award no later than 90 days after the end of the funding period, which means the State has two years and six months to liquidate its obligations.

CONDITION

The Department of Alcohol and Drug Programs (DADP) lacks adequate procedures to ensure that federal grant awards are obligated and spent within their applicable periods of availability for the Substance Abuse Prevention and Treatment Block Grant. In addition, it has not completed its corrective action on period of availability findings we reported in prior years related to the Safe and Drug-Free Schools program.

For the Substance Abuse Prevention and Treatment Block Grant program, DADP made payments to its subrecipients during fiscal year 2001-02 that it applied to grants awarded to it in 1998 and 1999. We found that DADP charged at least $145,491 to the grant awards for services that were provided after each award's period of availability had expired. Additionally, DADP charged $3,493 to a grant award although it drew down the funds from another grant award. Further, the services were

provided before the second grant award was available for obligation and expenditure. DADP implemented procedures in October 2001 to reconcile its Substance Abuse Prevention and Treatment Block Grant award expenditures with the federal awarding agency's Payment Management System. In addition, it refunded to the federal awarding agency the funds it drew down after the funding authority for several grant awards had expired. Thus, when DADP does not ensure that it charges expenditures within the appropriate period of availability, DADP risks having to refund the funds to the federal awarding agency.

Finally, DADP has not completed its corrective action related to findings we reported for the Safe and Drug-Free Schools program in fiscal years 1999-2000 and 2000-01. Specifically, for fiscal year 2000-01, we reported that DADP charged expenditures totaling $235,357 to the 1997 and 1999 grant awards outside their periods of availability. As of January 2003, DADP has yet to return these funds because it asserts that when it returned funds in 2001 related to the period of availability finding for fiscal year 1999-2000, it overpaid the federal government. DADP is working to resolve its overpayment before it repays any additional funds to the U. S. Department of Education for expenditures incurred outside the period of availability. Our review of expenditures during fiscal year 2001-02 found no reportable issues related to the period of availability for the Safe and Drug-Free Schools program.

RECOMMENDATIONS

DADP should strengthen its procedures to ensure it obligates and expends funds only during each grant award's period of availability. In addition, DADP should strengthen its procedures to determine appropriate adjustments to its accounting records, make the appropriate adjustments, and refund to the federal awarding agencies any Safe and Drug-Free Schools program funds and Substance Abuse Prevention and Treatment Block Grant program funds that it inappropriately spent outside the applicable periods of availability.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The U.S. Department of Health and Human Services publishes a Manual for Recipients Financed under the Payment Management System. Per the manual, block grant statutes govern the period in which states may obligate and expend funds. These statutes do not establish a time limit for drawing funds for legitimate expenditures. While block grants may be closed informally, the informal closing procedures do not affect a recipient's right to claim reimbursement for grant expenditures. Thus, the department will make the necessary adjustments on its accounting records to align obligations and expenditures with the period of availability.

With respect to the Safe and Drug Free Schools and Communities Act grant, DADP believes that approximately $500,000 is due it from the U.S. Department of Education. Thus, it will not return any funds until it completes the audit resolution process with the U.S. Department of Education.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.186
Federal Program Title:	Safe and Drug-Free Schools and Communities—State Grants
Federal Award Numbers and Calendar Years Awarded:	S186B70005; 1997 S186B990005; 1999

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.959
Federal Program Title:	Substance Abuse Prevention and Treatment Block Grant
Federal Award Numbers and Calendar Years Awarded:	99B1CASAPT; 1998 00B1CASAPT; 1999

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number:	2002-1-2
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0105CA5028; 2000 05-0205CA5028; 2001
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to activities allowed:

The Code of Federal Regulations, Title 42, Part 438, Subpart A, allows states to contract with managed care health plans (health plans) to provide health care to Medicaid beneficiaries. Under the terms of these contracts, the Department of Health Services (Health Services) pays the health plans a monthly enrollment fee for the Medicaid beneficiary. The contracts also allow Health Services to recover overpayments of any enrollment fees it pays the health plans after the beneficiary is no longer eligible.

CONDITION

During fiscal year 2001-02, Health Services did not always recover overpayments of Medicaid funds paid to health plans as enrollment fees for beneficiaries who were no longer eligible for Medicaid. As a result, Health Services allowed the health plans to retain Medicaid funds that they did not properly earn. We found that despite paying health plans almost $11,600 in monthly enrollment fees for 15 of the 21 deceased beneficiaries that we reviewed, Health Services had not recovered the funds as of August 2002. In these 15 instances, Health Services paid enrollment fees to the health plans for one to 12 months after the beneficiary had died. The section within Health Services responsible for this task told us that it had no staff assigned to recover these overpayments because it was waiting for management's approval to assign staff to do this.

RECOMMENDATION

Health Services should assign sufficient staff to recover any overpayments made to health plan.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Although Health Services recognizes that plans have been paid incorrectly on a number of deceased Medicaid beneficiaries, the current data systems do not easily compile the information for recovery purposes. Payment staff members within the Medi-Cal Managed Care Division (division) have always been assigned to calculate overpayments and pursue recoveries, but the problem has been with the system rather than with oversight. Currently, the division has identified the problem in the payment process and is working with Health Services' Information Systems Technology Division to generate reports that provide necessary and supplemental information to capture overpayment information by managed care plans.

Reference Number:	2002-1-3
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0105CA5028; 2000 05-0205CA5028; 2001
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to activities allowed:

The United States Code, Title 42, Section 1396, enables states to provide medical assistance to Medicaid beneficiaries. Additionally, the Code of Federal Regulations, Title 42, Part 456, requires states to provide methods and procedures to safeguard against the unnecessary utilization of care and services, which include conducting post-payment reviews, for the necessity, quality, and timeliness of these services.

CONDITION

The Department of Health Services (Health Services) did not always ensure that all services approved for Medicaid beneficiaries are supported by sufficient documentation. Because Health Services is required to conduct post-payment reviews, we requested that it conduct field reviews of client records and other pertinent documents to substantiate the medical necessity of the services billed to the Medicaid program for 31 claims that we reviewed. Health Services' review revealed that two of 31 claims did not have adequate support to substantiate a need for the provided services that the Medicaid program paid for. In the first instance, an out-of-state pharmacy provided medications for which the Medicaid program paid nearly $1,100. However, Health Services did not contact this pharmacy to request the documentation necessary to support the claim. Health Services' review of the second claim revealed differing opinions about whether adequate support existed to substantiate a beneficiary's need for a powered wheelchair that cost the Medicaid program about $5,500. Although Health Services' Medi-Cal Operations Division approved the beneficiary's request for the powered wheelchair, the Management Review Branch concluded after its examination that, although sufficient documentation existed to support the beneficiary's need for a wheelchair, it did not justify the need for a powered wheelchair.

RECOMMENDATIONS

Health Services should request all relevant supporting documentation when conducting post-payment reviews to ensure that services paid for by the Medicaid program are medically necessary. Further, Health Services should resolve the question of whether sufficient documentation exists to support the need for a powered wheelchair. If Health Services concludes that sufficient documentation does not in fact exist, it should take steps to recover the cost difference between the powered wheelchair and a non-powered wheelchair.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees that all relevant documentation should be collected when conducting post-payment reviews. Health Services states that it will determine whether sufficient documentation exists to support the need for the powered wheelchair noted in the finding. Health Services will recover the cost difference between powered wheelchairs and non-powered wheelchairs, if documentation is deemed insufficient. Policies have been in place since 1998 regarding criteria for adjudicating treatment authorization requests for custom wheelchairs. Health Services will ensure the criteria are followed.

Reference Number:	2002-3-5
Federal Catalog Number:	93.959
Federal Program Title:	Substance Abuse Prevention and Treatment Block Grant
Federal Award Numbers and Calendar Years Awarded:	00B1CASAPT-04; 1999 01B1CASAPT-04; 2000 02B1CASAPT-04; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Alcohol and Drug Programs

CRITERIA

Our review of the Substance Abuse Prevention and Treatment Block Grant program identified the following compliance requirements related to cash management:

The Code of Federal Regulations, Title 31, Part 205.7(b), requires the State to minimize the time between the transfer of funds from the U.S. Treasury and the disbursement of these funds for program puposes. Section 205.9 allows the State to enter into a Treasury-State agreement to set forth the terms and conditions for implementing this requirement. This agreement states that when the Department of Alcohol and Drug Programs (DADP) issues payments to local agencies for the Substance Abuse Prevention and Treatment Block Grant program, it will use the "pre-issuance" funding technique. When using the pre-issuance technique, state agencies must make every effort to request federal funds so they are deposited into a State account no more than two business days before the day the State makes a disbursement. The agreement also recognizes that due to variances in processing time, the two-day deposit requirement will be met for the majority, but not all, of the fund requests. Further, the Code of Federal Regulations, Section 205.17(l), states that the federal government may deny payment or credit for any federal interest liability resulting from the State's repeated or deliberate failure to request funds in accordance with the established funding technique set forth in the agreement.

CONDITION

DADP does not consistently use the appropriate funding technique to ensure that federal funds are deposited into its account no more than two business days before disbursement. Specifically, based on our testing, DADP exceeded the two-day deposit requirement for 48 (53 percent) of the 91 disbursements it made during the second quarter of fiscal year 2001-02. In addition, DADP exceeded the two-business-

day limit by one to 18 business days. Most of the disbursements exceeded the time limit by one or two business days. Further, we found that for all of fiscal year 2001-02 the Department of Finance calculated for the Substance Abuse Prevention and Treatment Block Grant program a weighted average of 7.02 days from when federal funds were deposited in a State account to when the funds were disbursed. For the disbursements we reviewed, DADP correctly reported the number of days from the deposit to the disbursement. However, because DADP did not consistently use the appropriate funding technique, the State incurred a $103,000 interest liability to the federal government.

RECOMMENDATIONS

DADP should implement procedures to ensure it uses the appropriate funding technique correctly. In addition, DADP should seek to minimize the time between the receipt and disbursement of federal funds. If DADP determines that the funding technique is no longer appropriate, it should request a change to the Treasury-State agreement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

DADP will review its funding technique procedures and implement any necessary procedures, which, depending on the outcome of its review, may include a request to change the Treasury-State agreement.

Reference Number:	2002-3-13
Federal Catalog Number:	93.667
Federal Program Title:	Social Services Block Grant
Federal Award Numbers and Calendar Years Awarded:	G-0101CASOSR; 2000 G-0201CASOSR; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Social Services

CRITERIA

Our review of the Social Services Block Grant program identified the following compliance requirements related to cash management:

The Code of Federal Regulations, Title 31, Part 205.7(b), requires the State to minimize the time between the transfer of funds from the U.S. Treasury and the disbursement of these funds for program purposes. Section 205.9 allows the State to enter into a Treasury-State agreement to set forth the terms and conditions for implementing this requirement. This agreement states that when the Department of Social Services (Social Services) issues payments to service providers and to state and local agencies for the Social Services Block Grant program it will use the "pre-issuance" funding technique. When using the pre-issuance technique, state agencies must make every effort to request federal funds so that they are deposited in a state account no more than two business days before the day the State makes a disbursement. The agreement also recognizes that because of variances in processing time, the two-day deposit requirement will be met for the majority, but not all, of the fund requests. Further, Section 205.17 states that the federal government may deny payment or credit for any federal interest liability resulting from the State's repeated failure to request funds according to the funding technique set forth in the agreement.

CONDITION

Social Services repeatedly failed to meet the two-day deposit requirement described in the agreement. Specifically, Social Services met the two-day deposit requirement for only seven (19 percent) of the 36 expenditures we tested. For the remaining 29 expenditures, the time elapsing from the deposit of federal funds to their disbursement ranged from six to 21 days; in one instance, the disbursement occurred 80 days after the deposit.

This situation occurred primarily for payments for the Social Services Block Grant's in-home support services component. Specifically, Social Services deposited $35.6 million in two separate transactions. The $35.6 million represents 97 percent of the Social Services Block Grant funds budgeted for this component. These deposits occurred during the third and fourth quarters of the fiscal year. However, this component operates continuously throughout the fiscal year. The first deposit totaling $18 million occurred on February 5, 2002, and the second totaling $17.6 million on April 26, 2002. Social Services then processed claim schedules daily until it had completely used the deposit balances. For example, the last payment for the second deposit occurred on May 17, 2002, 21 days after the initial deposit date. Further, Social Services did not implement an adequate system to ensure it met the two-day deposit requirement even though it has systems in place for other programs it administers that are also subject to the two-day deposit requirement. Specifically, Social Services did not attach a yellow cover sheet to Social Services Block Grant claim schedules for the 36 transactions we reviewed, including the in-home support services component, as requested by the Department of Finance (Finance). The yellow cover sheet was developed by the State Controller's Office to ensure disbursements within two days of the deposit of federal funds. For all of these payments, Finance has used the correct deposit and disbursement data in its calculation of interest liability. However, when Social Services does not consistently use the agreed-upon technique, the federal government may not pay its resulting interest liability.

RECOMMENDATIONS

To ensure that it meets the two-day deposit requirement for the Social Services Block Grant, Social Services should implement the agreed-upon funding technique. If Social Services determines that the agreed-upon funding technique is no longer appropriate, it should request a change to the Treasury-State agreement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Social Services concurs with the recommendation and will adhere to the Treasury-State Agreement established new reporting requirements for the Social Services Block Grant (SSBG) under the Cash Management Improvement Act (CMIA) effective July 1, 2001. Previous Treasury-State agreements restricted the State to only 1/13th of the SSBG quarterly grant award per week, but held both the State and Federal governments as interest neutral. Social Services found the limited funds access created significant cash management difficulties and requested the agreement be revised. In implementing the new reporting requirements, however, Social Services found the traditional CMIA funding technique does not accurately represent the true funding aspects of each SSBG program, such as is the case of the in-home support services program. Basically, the in-home support services program is funded primarily by the state general fund in the first instance, thus negating any interest liability to the federal government. Traditional CMIA reporting did not lend itself to capturing the true funding for this program without creating additional administrative burden for both Social Services staff and the State Controller's Office staff. Social Services has discussed this matter with Finance and Finance recommended that prior to the approval of the next Treasury-State Agreement, Social Services should meet with Finance to review other funding techniques that may be more appropriate for these types of payments and to look at implementing different funding techniques for each program funded by SSBG.

In addition, the Social Services Fund Accounting and Reporting Bureau (FARB) is now including the yellow cover sheet for SSBG payments when they are transferred to the State Controller's Office. Procedures for the cover sheet are also included in the FARB's CMIA Procedures Manual.

Reference Number:	2002-9-5
Category of Finding:	Suspension and Debarment
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 Special Programs for the Aging—Title III, Part B, Grants for Supportive Services and Senior Centers, and Special Programs for the Aging—Title III, Part C, Nutrition Services (aging programs) identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 45, Section 76.225(a), prohibits the State from knowingly doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. Further, Section 76.510(b) requires the State to obtained signed certifications from participating organizations regarding suspension, debarment, ineligibility, and voluntary exclusion.

CONDITION

The Department of Aging (Aging) does not have a process to determine whether its subrecipients are suspended or debarred from participating in federal programs. Specifically, Aging did not verify whether any of its 33 subrecipients that participated in the aging programs were suspended or debarred during fiscal year 2001-02. Aging provided these subrecipients approximately $60 million in federal funding during fiscal year 2001-02. When Aging does not verify a subrecipient's suspension and debarment status, it risks unknowingly allowing suspended or debarred parties to inappropriately participate in federal programs. For the 10 subrecipients we reviewed, we used an alternative test to determine that they were not suspended or debarred.

RECOMMENDATION

Aging should implement procedures to ensure that it obtains the necessary suspension and debarment certificates from subrecipients before it approves their participation in federal programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Aging agrees with the finding and will implement procedures to ensure that subrecipients are not suspended or debarred.

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:	02-01-AA-CA-1320; 2000 02-02-AA-CA-1320; 2001

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:	02-01-AA-CA-1712; 2000 02-01-AA-CA-1713; 2000 02-02-AA-CA-1712; 2001 02-02-AA-CA-1713; 2001

Reference Number:	2002-12-7
Federal Catalog Number:	93.994
Federal Program Title:	Maternal and Child Health Services Block Grant to the States
Federal Award Numbers and Calendar Years Awarded:	6B04MC00336-04; 2000 6B04MC00336-05; 2001
Category of Finding:	Reporting
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Maternal and Child Health Services Block Grant to the States (program) determined that the following compliance requirements apply to reporting:

The United States Code, Title 42, Section 706(a), requires the State to prepare and submit an annual report concerning its program activities. This annual report must contain accurate information pertaining to the description of such activities, a complete record of the purposes for which the funds were spent, and a description of the extent

to which the State has met certain program goals. Additionally, federal guidelines for completing the report allow the use of estimates if actual numbers are unavailable, but require the State to explain all estimates in a footnote.

CONDITION

The Department of Health Services (Health Services) does not always use complete data in its annual program report to the U.S. Department of Health and Human Services nor does it always disclose its use of estimates. Specifically, the expenditure data included in the program report relies, in part, on information from an annual report from the Child Health and Disability Prevention (CHDP) program. The CHDP program report discloses that the expenditures for the nearly 2.2 million children it serves are understated because the CHDP program does not collect expenditure data for approximately 735,000 children that are served by Medicaid managed care providers. Further, in reporting the primary sources of health coverage for children with special health care needs, Health Services did not disclose that it used average caseloads from county administrative claims to estimate the number of children served.

When Health Services does not report complete data and does not identify and explain all estimates that it uses in its annual report to the federal government, the U.S. Department of Health and Human Services may be unable to make a sound assessment of the program's success in enhancing the well-being of mothers and children.

RECOMMENDATIONS

In its annual report to the U.S. Department of Health and Human Services, Health Services should either provide complete numbers or use estimates if actual numbers are unavailable. Additionally, Health Services should identify and explain all estimates that it uses.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services concurs with the findings and recommendation. In future reports to the U.S. Department of Health and Human Services made pursuant to Section 706(a) of Title 42 of the United States Code that utilize information from the annual report of the Child Health and Disability Prevention Program, actual caseload and expenditure data will be utilized when available. When caseload or expenditure numbers that are estimates are utilized, these numbers will be footnoted to characterize them as estimates and an explanation of the reason and basis for the estimate will be provided.

Reference Number:	2002-12-8
Federal Catalog Number:	93.568
Federal Program Title:	Low-Income Home Energy Assistance
Federal Award Numbers and Calendar Years Awarded:	G-00B1CALIEA; 2000 G-0101CALIE3; 2000 G-01B2CALIEA; 2000
Category of Finding:	Reporting
State Administering Department:	Department of Community Services and Development

CRITERIA

Our review of the Low-Income Home Energy Assistance program determined that the following compliance requirements relate to reporting:

The Code of Federal Regulations, Title 45, Section 96.82, requires the State to submit annually to the U.S. Department of Health and Human Services the data required by the United States Code, Title 42, Section 8624(c)(1)(G). These data are for the 12-month period corresponding to the federal fiscal year preceding the fiscal year for which funds are requested. Under the requirements of Section 8624(c)(1)(G), the State must prepare and submit a plan that reports the number and income levels of households that apply for assistance and the number that are assisted with federal funds. Further, the State must report the number of households assisted that have one or more members who are at least 60 years old, have one or more members who are disabled, and have one or more young children.

CONDITION

In its Low-Income Home Energy Assistance Program Household report (report) for federal fiscal year 2001, the Department of Community Services and Development (Community Services) did not accurately report the number of the households it served and the demographics of these households.

Specifically, Community Services did not require its subrecipients to report the demographic information for the number of households served under the home-energy assistance and winter/year-around-crisis components of the program in one large service area from October 2000 through January 2001. Although Community Services disclosed the total number of households served in this area as a footnote in the report, the amounts were incorrect. For example, it reported that it

assisted 4,729 households under the home-energy assistance component and 790 households under the winter/year-around-crisis component, when it actually assisted 5,466 households and 53 households, respectively.

Further, Community Services reported that it assisted 7,707 households with at least one member who is 60 years or older under the winter/year-around-crisis component when it actually assisted 10,286 households.

When Community Services does not report the correct information, the federal government does not have accurate data on households receiving assistance under the Low-Income Home Energy Assistance program.

RECOMMENDATIONS

Community Services should require its subrecipients to report demographic data, and it should ensure it accurately reports the number of households receiving assistance and the correct demographic data under each program component in its annual report.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

As required by the United States Code, Title 42, Section 8624(c)(1)(G), Community Services mandates that all Low Income Home Energy Assistance Program (LIHEAP) Service Providers report LIHEAP demographic data for the number of households receiving assistance. During California's energy crisis, the federal government released a series of LIHEAP Emergency Contingency Funds (ECF) in response to a sudden rise in fuel prices. In particular, Southern California was impacted severely and Community Services contracted with three LIHEAP Service Providers to provide immediate cash assistance benefits. To immediately execute the intended use of these emergency funds, and to meet the immediate energy crisis-related needs of the low-income population in Southern California, Community Services considered two possible options**:** (1) Utilize the California LIHEAP Automated Service System (CLASS) extranet database (that networks Community Services and LIHEAP Service Providers) to collect data and issue cash assistance benefits. Implementation of this option would require Community Services to reprogram the CLASS system and delay the disbursement of ECF-LIHEAP funds an additional two to three months. (2) Allow the Southern California LIHEAP Service Providers to administer the cash assistance program directly with utility companies without utilizing the CLASS system. Because of the emergency nature of these funds, and the need to disburse funds as quickly as possible to service clients in crisis, Community Services selected option two. As a result, the LIHEAP Service Providers captured the demographic data at the local level, but were not required to report this data to Community Services for this particular ECF-LIHEAP funding release. While the specific demographic data was not reported, Community Services did report the overall additional households served to the U. S. Department of Health and Human Services as a footnote on the 2001 Household Report.

Subsequently, for the third, fourth, and fifth releases of ECF-LIHEAP funds, Community Services reprogrammed CLASS to allow the LIHEAP Services Providers to utilize CLASS to capture and report household and demographic data.

In addition, Community Services will ensure that all demographic data accurately reflects the number of households receiving assistance, and that the correct demographic data is collected and reported under each program component in its annual report.

Reference Number:	2002-13-7
Federal Catalog Number:	93.569
Federal Program Title:	Community Services Block Grant
Federal Award Numbers and Calendar Years Awarded:	G-99B1CACOSR; 1998 G-00B1CACOSR; 1999 G-01B1CACOSR; 2000
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Community Services and Development

CRITERIA

Our review of the Community Services Block Grant (program) identified the following compliance requirements related to subrecipient monitoring:

The United States Code, Title 42, Section 9914 (a)(1), requires the State to conduct at least once every three years a full on-site review of each subrecipient that receives program funds to ensure they meet the performance goals and administrative and financial requirements of the program.

To implement this requirement, the Department of Community Services and Development (Community Services) has developed a monitoring policy that requires it to inform subrecipients of deficiencies identified during on-site reviews and requires the subrecipients to respond with a corrective action plan within 30 days or other agreed-upon time of receiving the monitoring report detailing the deficiencies. The policy also requires Community Services to send letters to its subrecipients at 30 days and 60 days after the due date when it does not receive corrective action plans and to maintain a tracking status report to document its communications with the subrecipient. Should the subrecipient not respond within 90 days after the due date,

the policy requires Community Services to send a letter signed by its deputy director and requires the subrecipient to respond to the letter within 10 days. If the subrecipient does not respond within the 10-day period, the monitoring report with the related reminder letters are referred to Community Services' chief deputy director for disposition.

CONDITION

Community Services did not always require its subrecipients to develop and implement corrective action plans within 30 days or other agreed-upon times when it identified deficiencies during on-site reviews. Specifically, 15 of the 20 reports of on-site visits we reviewed contained deficiencies that required corrective action plans. However, Community Services received only seven within the agreed-upon time and received the remaining eight corrective action plans from five to 359 days late. Although we noted that Community Services sends letters to its subrecipients at 30 days and 60 days after the due date when it does not receive corrective action plans, it could only provide evidence of its contacting five of the subrecipients for which it had not received corrective action plans within the agreed-upon time.

The majority of the deficiencies noted in the on-site reviews include board member vacancies, late reporting, and inadequate appeal procedures. However, these deficiencies do not appear to require a complex corrective action plan that would take an extended amount of time to prepare. For example, a corrective action plan for a board member vacancy could include a recruitment and selection process plan with timelines for filling vacant positions, which could be prepared within the agreed-upon time. However, Community Services received only six of the 13 corrective action plans addressing board member vacancy deficiencies within the agreed-upon time.

When Community Services does not receive corrective action plans promptly, it cannot ensure that its subrecipients administer their programs in compliance with the performance goals and administrative and fiscal requirements of the grant.

RECOMMENDATION

To ensure that its subrecipients meet the performance goals and administrative and financial requirements of the program, Community Services should more closely follow its monitoring policy to ensure its subrecipients submit corrective action plans within the agreed-upon time.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

During the 1999, 2000, and 2001 program years, the Community Services Field Operations Unit encountered a high turnover in staff, specifically in the area in which the Bureau of State Audits identified the audit finding. Community Services recognizes that during these program years, follow-up to responses of corrective actions and approval was not always done in a timely manner by field representatives.

Since 2002, the Unit has maintained almost full staffing of field representatives, and has been able to monitor its contractors in accordance with the established Monitoring Process and Procedures, to ensure that they meet appropriate standards, goals, and administrative and financial requirements of the Community Services Block Grant program. In the future, Field Operations Unit will adhere to its internal Monitoring Policies and Procedures and ensure that responses to corrective actions are submitted by contractors within the timeframe agreed upon.

Reference Number:	2002-14-3
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0105CA5028; 2001 05-0205CA5028; 2002
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 45, Section 95.621, requires the State to conduct a biennial security review of automatic data processing systems used in the administration of Health and Human Services programs.

CONDITION

The Department of Health Services (Health Services) did not review the security of its automatic data processing systems biennially as required. Each year, independent auditors review different components of the automated system used to process claims submitted by Medicaid service providers so that a complete review of system security is done every three years, rather than every two years as required by federal regulations. With less frequent system security reviews, Health Services has reduced assurance that its automatic data processing systems are adequately protected, since potential exceptions may go unnoticed or unresolved for longer periods of time.

RECOMMENDATION

Health Services should revise the approach it uses to conduct the review of its automated system in order to achieve a biennial, rather than a triennial, security review.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees with the recommendation and will conduct biennial security reviews as required by the Code of Federal Regulations, Title 45, Section 95.621. Health Services is in the process of changing the scope of an annual review to include security reviews every two years, instead of every three years.

Reference Number:	2002-14-5
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0105CA5028; 2001 05-0205CA5028; 2002
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to medical service providers:

The Code of Federal Regulations, Title 42, Section 431.107, requires the State to provide for an agreement between each provider and the state agency administering the Medicaid program. The provider must agree to disclose certain information, including any ownership or controlling interest in any other entity that is paid Medicaid funds, as outlined in sections 455.104 through 455.106. Further, Section 455.104 requires providers to submit their disclosures when their facilities are surveyed or before they enter into agreements to participate in Medicaid.

CONDITION

The Department of Health Services (Health Services) does not have adequate controls over provider agreements. Specifically, our review revealed that Health Services could not provide agreements for six of 31 providers we reviewed. Further, Health Services could not provide any disclosure information for six providers. Other testing we performed identified an additional provider for which Health Services could not provide disclosure information. When Health Services cannot demonstrate that it obtained the required provider agreements and disclosures, it cannot ensure that it made Medicaid claim payments only to authorized providers.

Health Services said it has developed an expanded provider agreement and is continuing the process of re-enrolling existing providers. Because approximately 135,000 providers exist, Health Services prioritized its re-enrollment process and started to re-enroll higher-risk providers in June 1999. Health Services estimates that it has re-enrolled about 770 providers and placed another 820 on inactive status.

RECOMMENDATION

Health Services should continue with its re-enrollment process of renewing provider files so that provider agreements, disclosure of significant beneficial interest, and other pertinent provider information is reasonably current.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees with the recommendation. With the passage of the Governor's Budget for fiscal year 2002-03, and the approval of 20 new positions, Health Services established a new Re-Enrollment Section within Payment Systems Provider Enrollment Branch to fully expand the anti-fraud activities and incorporate the re-enrolling of all provider types on a rotating basis with a focus on pharmacy providers.

Additionally, new business entity emergency regulations were enacted on February 4, 2003, that expand business disclosure and insurance information requirements for all providers and the Provider Enrollment Branch began the first phase of the re-enrollment process and mail-outs to 328 pharmacies and 300 physicians. The second phase will focus on re-enrolling all provider types on a rotating basis.

U.S. SOCIAL SECURITY ADMINISTRATION

Reference Number:	2002-3-12
Federal Catalog Number:	96.001
Federal Program Title:	Social Security—Disability Insurance
Federal Award Numbers and Calendar Years Awarded:	0104CADI00; 2000 0204CADI00; 2001
Category of Finding:	Cash Management
State Administering Department:	Department of Social Services

CRITERIA

We determined that the following requirements relate to compliance with the Cash Management Improvement Act Agreement (CMIA agreement) between the U.S. Department of the Treasury and the State:

The CMIA agreement, sections 9.4.1 and 9.6.1, establishes requirements for calculating the State's interest liability. Sections 9.4.3 and 9.6.2 provide the methods for calculating this interest liability.

CONDITION

The Department of Finance (Finance) requires state departments to report information related to the receipt and disbursement of federal funds so that Finance can calculate the State's interest liability under the CMIA agreement. However, our review of the worksheet that the Department of Social Services (Social Services) submitted to Finance for the Social Security—Disability Insurance program found that Social Services did not always accurately report its draw amounts or dates for three of the five draw downs on one quarterly worksheet.

Specifically, Social Services reported that it drew down $16 million on May 24, 2002, when it actually drew down $16.5 million. For another draw down occurring two weeks later, Social Services reported that it drew down $14 million when it actually drew down $13.5 million. Social Services also incorrectly reported the date of the draw down as June 25, 2002, instead of June 7, 2002. In another instance, Social Services reported that it drew $993,715 on May 25, 2002, instead of May 28, 2002. When Social Services does not accurately report the dates and the amount of funds drawn, it causes Finance to incorrectly calculate the amount of the State's interest liability. If Finance had left these errors uncorrected, it would have understated the State's interest liability by $15,501.

RECOMMENDATION

Social Services should ensure that the quarterly worksheets it submits to Finance accurately report draw amounts and dates.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Social Services concurs with the recommendation. Recent changes and expansion of reporting of CMIA costs for state operation activities had created confusion and inconsistency in how staff was to report draws and offsets. Since the time of this finding, staff has attended CMIA training on August 29, 2002, and has held a separate discussion with the Department of Finance Fiscal Systems and Consulting unit staff responsible for CMIA in October 2002 to clarify reporting policies. The Social Services Fund Accounting and Reporting Bureau has also developed a more detailed CMIA procedure manual to further assist staff in the reporting of various situations encountered. The manual specifically states that the "draw" amount on the Administrative Cost Worksheet should equal the amount drawn per the "Plan of Financial Adjustment " process. Instructions for the "date" specify that this should be the date posted by the State Controller's Office. Our compliance with these instructions will eliminate this finding in the future, however, it is to be noted that reporting of CMIA amounts and dates represent a manual posting of a quarter's federal draws and unfortunately are subject to key data errors, especially in the case of transaction dates.

AUDITEE'S SECTION

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Schedule of Federal Assistance

Prepared by
Department of Finance

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STATE OF CALIFORNIA
SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2002

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Agriculture		
Market Protection and Promotion	10.163	$ 435,075
Farm Labor Housing Loans and Grants	10.405	1,060,890
Food Distribution	10.550	98,762,199 *
Special Supplemental Food Program for Women, Infants, and Children	10.557	761,503,870
Child and Adult Care Food Program	10.558	216,505,105
State Administrative Expenses for Child Nutrition	10.560	17,043,376
Commodity Supplemental Food Program	10.565	2,322,921
Nutrition Program for the Elderly	10.570	12,113,287
WIC Farmers' Market Nutrition Program (FMNP)	10.572	1,803,110
Team Nutrition Grants	10.574	155,122
Cooperative Forestry Assistance	10.664	1,180,979
National Forest-Dependent Rural Communities	10.670	593,027
Rural Business Enterprise Grants	10.769	98,653
Wildlife Habitat Incentive Program	10.914	563
Specialty Crops	10.999	63,820,000
Other - U.S. Department of Agriculture	10.999	16,516,499
Total Excluding Clusters		1,193,914,676
Food Stamp Cluster		
Food Stamps	10.551	1,619,714,000 *
State Administrative Matching Grants for Food Stamp Program	10.561	287,377,404
Total Food Stamp Cluster		1,907,091,404
Child Nutrition Cluster		
School Breakfast Program	10.553	202,426,134
National School Lunch Program	10.555	806,599,240
Special Milk Program for Children	10.556	825,378
Summer Food Service Program for Children	10.559	20,290,008
Total Child Nutrition Cluster		1,030,140,760

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Emergency Food Assistance Cluster		
Emergency Food Assistance Program	10.568	7,979,023
Emergency Food Assistance (commodities)	10.569	66,921,000 *
Total Emergency Food Assistance Cluster		74,900,023
Research & Development Cluster		
USDA/Agricultural Research Service	10.001	10,423 **
Schools and Roads Cluster		
Schools and Roads Cluster - Grants to States	10.665	61,908,622
Total U.S. Department of Agriculture		4,267,965,908
Department of Commerce		
Economic Development-Support for Planning Organizations	11.302	100,000
Sudden and Severe Economic Dislocation	11.311	15,016,422 ***
Anadromous Fish Conservation Act Program	11.405	399,996
Interjurisdictional Fisheries Act of 1986	11.407	120,354
Coastal Zone Management Administration Awards	11.419	3,466,130
Coastal Zone Management Estuarine Research Reserves	11.420	289,254
Marine Sanctuary Program	11.429	28,245
Pacific Coast Salmon Recovery-Pacific Salmon Treaty Program	11.438	1,488,007
Habitat Conservation	11.463	88,058
Office of Administration Special Programs	11.470	2,360
Technology Opportunities	11.552	52,115
Other - U.S. Department of Commerce	11.999	92,576
Total Excluding Clusters		21,143,517
Research & Development Cluster		
Office of Administration Special Programs	11.470	3,152
Total U.S. Department of Commerce		21,146,669

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Defense		
Planning Assistance to States	12.110	750,000
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113	7,434,589
National Guard Military Operations and Maintenance - (O&M) Projects	12.401	56,129,243
Total Excluding Clusters		64,313,832
Research & Development Cluster		
Aquatic Plant Control	12.100	149,580
Total U.S. Department of Defense		64,463,412
Department of Housing and Urban Development		
Manufactured Home Construction and Safety Standards	14.171	179,660
Community Development Block Grants/State's Program	14.228	48,554,516
Emergency Shelter Grants Program	14.231	5,038,105
Supportive Housing Program	14.235	5,450,460 ***
HOME Investment Partnerships Program	14.239	69,136,187 ***
Housing Opportunities for Persons with AIDS	14.241	2,143,767
Equal Opportunity in Housing	14.400	2,591,193
Lead-Based Paint Hazard Control Priority Housing	14.900	357,111
Total Excluding Clusters		133,450,999
Section 8 Project-Based Cluster		
Lower Income Housing Assistance Program - Section 8 Moderate Rehabilitation	14.856	71,348
Section 8 Tenant-Based Cluster		
Section 8 Rental Voucher Program	14.855	2,871,887
Total U.S. Department of Housing and Urban Development		136,394,234

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of the Interior		
Small Reclamation Projects	15.503	288,101
Anadromous Fish Conservation	15.600	21,924
Environmental Contaminants	15.607	30,834
Fish and Wildlife Management Assistance	15.608	593,098
Endangered Species Conservation	15.612	217,279
Coastal Wetlands Planning, Protection and Restoration Act	15.614	1,539,146
Cooperative Endangered Species Conservation Fund	15.615	2,983,307
Clean Vessel Act	15.616	590,000
Wildlife Conservation and Appreciation	15.617	32,000
Geological Survey-Research and Data Acquisition	15.808	152,074
Historic Preservation Fund Grants-In-Aid	15.904	1,193,013
Outdoor Recreation-Acquisition, Development and Planning	15.916	2,653,130
Native American Graves Protection and Repatriation	15.922	4,497
Research Information	15.975	190,028
Other - U.S. Department of the Interior	15.999	27,611,406
Total Excluding Clusters		38,099,837
Fish and Wildlife Cluster		
Sport Fish Restoration	15.605	10,442,403
Wildlife Restoration	15.611	5,499,511
Total Fish and Wildlife Cluster		15,941,914
Research and Development Cluster		
Anadromous Fish Conservation	15.600	13,313
Fish and Wildlife Management Assistance	15.608	173,686
Coastal Wetlands Planning, Protection and Restoration Act	15.614	3,414
Cooperative Endangered Species Conservation Fund	15.615	11,620
Total Research and Development Cluster		202,033
Total U.S. Department of the Interior		54,243,784
Department of Justice		
State Domestic Preparedness Equipment Support Program	16.007	1,835,140
Juvenile Accountability Incentive Block Grants	16.523	28,429,816
Juvenile Justice and Delinquency Prevention-Allocation to States	16.540	12,010,195

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Juvenile Justice and Delinquency Prevention - Special Emphasis	16.541	6,012,241
Part E-State Challenge Activities	16.549	1,641,309
National Criminal History Improvement Program	16.554	6,195,908
National Sex Offender Registry Assistance	16.555	716,181
Crime Laboratory Improvement-Combined Offender DNA Index System Backlog Reduction	16.564	389,463
Crime Victim Assistance	16.575	50,063,105
Crime Victim Compensation	16.576	32,819,000
Byrne Formula Grant Program	16.579	54,138,523
Drug Court Discretionary Grant Program	16.585	244,996
Violent Offender Incarceration and Truth in Sentencing Incentive Grants	16.586	43,997,820
Violence Against Women Formula Grants	16.588	16,771,470
Rural Domestic Violence and Child Victimization Enforcement Grant Program	16.589	2,842,046
Grants to Encourage Arrest Policies and Enforcement of Protection Orders	16.590	100,824
Local Law Enforcement Block Grants Program	16.592	1,189,623
Residential Substance Abuse Treatment for State Prisoners	16.593	5,405,076
Corrections-Research and Evaluation and Policy Formulation	16.602	492,077
State Criminal Alien Assistance Program	16.606	301,327,998
Bulletproof Vest Partnership Program	16.607	1,275,000
Regional Information Sharing Systems	16.610	3,934,137
Public Safety Partnership and Community Policing Grants ("COPS" Grants)	16.710	9,184,802
Other - U.S. Department of Justice	16.999	1,215,549
Total Excluding Clusters		582,232,299
Research and Development Cluster		
Violence Against Women Formula Grants	16.588	10,487
Total U.S. Department of Justice		582,242,786

Department of Labor

Labor Force Statistics	17.002	7,342,932
Compensation and Working Conditions Data	17.005	939,438
Labor Certification for Alien Workers	17.203	6,420,827
Unemployment Insurance	17.225	5,225,800,893
Senior Community Service Employment Program	17.235	7,380,422

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Trade Adjustment Assistance-Workers	17.245	11,077,264
Employment Services and Job Training - Pilot and Demonstration Programs	17.249	4,176,668
Welfare-to-Work Grants to States and Localities	17.253	89,193,838
Workforce Investment Act	17.255	300,682,731
Occupational Safety and Health-State Program	17.503	22,712,427
Consultation Agreements	17.504	4,948,221
Mine Health and Safety Grants	17.600	143,373
Veterans' Employment Program	17.802	939,474
Other-U.S. Department of Labor	17.999	91,106
Total Excluding Clusters		5,681,849,614
Employment Services Cluster		
Employment Service	17.207	83,750,175
Disabled Veterans' Outreach Program	17.801	11,343,673
Local Veterans' Employment Representative Program	17.804	6,924,996
Total Employment Services Cluster		102,018,844
WIA CLUSTER		
WIA Adult Program	17.258	93,071,837
WIA Youth Activities	17.259	99,162,513
WIA Dislocated Workers	17.260	105,605,752
Total WIA Cluster		297,840,102
JTPA Cluster		
Employment and Training Assist - Dislocated Workers	17.246	5,307,380
Job Training Partnership Act	17.250	4,432,320
Total JTPA Cluster		9,739,700
Total U.S. Department of Labor		6,091,448,260
Department of Transportation		
Boating Safety Financial Assistance	20.005	3,855,067
Airport Improvement Program	20.106	373,003
Motor Carrier Safety	20.217	9,744,133
Local Rail Freight Assistance	20.308	969,212
Federal Transit - Metropolitan Planning Grants	20.505	45,101,563
Formula Grants for Other Than Urbanized Areas	20.509	10,596,656

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Pipeline Safety	20.700	886,684
Interagency Hazardous Materials Public Sector Training and Planning Grants	20.703	922,971
Total Excluding Clusters		72,449,289
Highway Planning and Construction Cluster		
Highway Planning and Construction	20.205	2,466,593,452 ***
Federal Transit Cluster		
Federal Transit Capital Improvement Grants	20.500	8,729,686
Highway Safety Cluster		
State and Community Highway Safety	20.600	43,867,594
Research and Development Cluster		
Highway Planning and Construction	20.205	19,429,590
Formula Grants for Other Than Urbanized Areas	20.509	154,289
State Planning and Research	20.515	1,772,769
Total Research & Development Cluster		21,356,648
Total U.S. Department of Transportation		2,612,996,669
Department of Treasury		
Other - U.S. Department of Treasury	21.999	115,821
Equal Employment Opportunity Commission		
Employment Discrimination-State and Local Fair Employment Practices Agency Contracts	30.002	3,035,500
General Services Administration		
Donation of Federal Surplus Personal Property	39.003	9,757,744 **
National Aeronautics and Space Administration		
Technology Transfer	43.002	321,337

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
National Foundation on the Arts and the Humanities		
Promotion of the Arts-State and Regional Program	45.007	700,800
State Library Program	45.310	15,060,007
Total National Foundation on the Arts and Humanities		15,760,807
Small Business Administration		
Small Business Development Center	59.037	8,377,592
Department of Veterans Affairs		
Veterans State Domiciliary Care	64.014	9,302,620
Veterans State Nursing Home Care	64.015	7,152,299
Veterans State Hospital Care	64.016	116,420
Veterans Housing-Guaranteed and Insured Loans	64.114	411,555,951 ***
All Volunteer Force Educational Assistance	64.124	51,806
Other-U.S. Department of Veterans Affairs	64.999	1,385,010
Total U.S. Department of Veteran's Affairs		429,564,106
Environmental Protection Agency		
Air Pollution Control Program Support	66.001	202,337
State Indoor Radon Grants	66.032	229,343
Water Pollution Control-State and Interstate Program Support	66.419	6,500,276
State Underground Water Source Protection	66.433	337,892
Water Quality Management Planning	66.454	1,267,370
National Estuary Program	66.456	259,590
Capitalization Grants for State Revolving Funds	66.458	466,608,726 ***
Non-point Source Implementation Grants	66.460	9,133,759
Wetlands Grants	66.461	354,828
Water Quality-Cooperative Agreements	66.463	766,963
Capitalization Grants for Drinking Water State Revolving Fund	66.468	45,020,089 ***
Environmental Protection Consolidated Research	66.500	1,128
Safe Drinking Water Research and Demonstration	66.506	5,044,356

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Toxic Substances Research	66.507	109,844
Surveys, Studies, Investigations and Special Purpose Grants	66.606	629,083
Consolidated Pesticide Compliance Monitoring and Program Cooperative Agreements	66.700	1,448,860
Toxic Substances Compliance Monitoring Cooperative Agreements	66.701	88,339
TSCA Title IV State Lead Grants-Certification of Lead-Based Paint Professionals	66.707	799,155
Pollution Prevention Grants Program	66.708	237,316
Hazardous Waste Management State Program Support	66.801	8,887,960
Superfund State Site-Specific Cooperative Agreements	66.802	3,241,530
State and Tribal Underground Storage Tanks Program	66.804	139,255
Leaking Underground Storage Tank Trust Fund Program	66.805	3,737,818
Solid Waste Management Assistance	66.808	37,715
Total Excluding Clusters		555,083,532
Research and Development Cluster		
Wetlands Grants	66.461	75,291
Surveys, Studies, Investigations and Special Purpose Grants	66.606	17,825
Consolidated Pesticide Compliance Monitoring and Program Cooperative Agreements	66.700	475,637
Pollution Prevention Grants Program	66.708	124,080
Illness Data Enhancement	66.999	65,956
Total Research and Development Cluster		758,789
Total U.S. Environmental Protection Agency		555,842,321
Department of Energy		
State Energy Conservation	81.041	6,055,479
Weatherization Assistance for Low-Income Persons	81.042	4,750,068
Renewable Energy Research and Development	81.087	544,972
Environmental Restoration	81.092	382,406
National Industrial Competitiveness Through Energy, Environment, and Economics	81.105	613,754
Other-U.S. Department of Energy	81.999	256,268
Total Department of Energy		12,602,947

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Federal Emergency Management Agency		
State Disaster Preparedness Grants	83.505	421,036
Earthquake Hazards Reduction Grants	83.521	76,948
Emergency Management-State and Local Assistance	83.534	119,135
Flood Mitigation Assistance	83.536	682,920
Public Assistance Grants	83.544	409,467,970
Hazard Mitigation Grant	83.548	134,341,813
Project Impact: Building Disaster Resistant Communities	83.551	45,130
Emergency Management Performance Grants	83.552	10,557,055
Pre-Disaster Mitigation	83.557	30,000
Other-Federal Emergency Management Agency	83.999	853,692
Total Federal Emergency Management Agency		556,595,699
Department of Education		
Adult Education-State Grant Program	84.002	59,266,472
Title I Grants to Local Educational Agencies	84.010	1,152,384,512
Migrant Education-Basic State Grant Program	84.011	98,254,128
Title I Program for Neglected and Delinquent Children	84.013	4,134,212
Vocational Education-Basic Grants to States	84.048	112,125,377
Vocational Education-State Councils	84.053	325,498
Leveraging Educational Assistance Program	84.069	9,480,438
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	237,780,316
Rehabilitation Services-Service Projects	84.128	1,307,786
Public Library Construction and Technology Enhancement	84.154	689,648
Immigrant Education	84.162	31,535,653
Independent Living-State Grants	84.169	2,024,273
Rehabilitation Services-Independent Living Services for Older Individuals Who are Blind	84.177	1,934,493
Special Education-Grants for Infants and Families with Disabilities	84.181	42,116,701
Byrd Honors Scholarships	84.185	2,783,755
Safe and Drug-Free Schools-State Grants	84.186	52,800,511
Supported Employment Services for Individuals with Severe Disabilities	84.187	4,386,015
Bilingual Education Support Services	84.194	1,229,435
Bilingual Education-Professional Development	84.195	95,000
Education for Homeless Children and Youth	84.196	4,927,924

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Even Start-State Educational Agencies	84.213	24,635,342
Capital Expenses	84.216	2,808,702
Assistive Technology	84.224	1,295,718
Tech-Prep Education	84.243	8,844,098
Rehabilitation Training-State Vocational Rehabilitation Unit In-Service Training	84.265	564,853
Goals 2000-State and Local Education Systematic Improvement Grants	84.276	42,066,675
School to Work Opportunities	84.278	26,490,349
Eisenhower Professional Development State Grants	84.281	43,577,680
Charter Schools	84.282	8,899,861
Foreign Language Assistance	84.293	38,536
Innovative Education Program Strategies	84.298	45,097,216
Even Start-Statewide Family Literacy Program	84.314	548,923
Technology Literacy Challenge Fund Grants	84.318	40,891,636
Special Education-State Program Improvement Grants for Children with Disabilities	84.323	1,784,244
Advanced Placement Incentive Program	84.330	150,681
Grants to States for Incarcerated Youth Offenders	84.331	1,718,401
Comprehensive School Reform Demonstration	84.332	23,162,925
Teacher Quality Enhancement Grants	84.336	2,159,975
Reading Excellence	84.338	24,937,846
Class Size Reduction	84.340	84,603,692
Preparing Tomorrow's Teachers to Use Technology	84.342	733,968
Total Excluding Clusters		2,204,593,468
Student Financial Aid Cluster		
Federal Family Education Loans	84.032	22,324,502,953 ***
Special Education Cluster		
Special Education - Grants to States	84.027	637,663,323
Special Education - Preschool Grants	84.173	57,626,472
Total Special Education Cluster		695,289,795
Total U.S. Department of Education		25,224,386,216
Consumer Product Safety Commission		
Other-Consumer Product Safety Commission	87.999	51,725

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Health and Human Services		
Special Programs for the Aging-Title VII, Chapter 3-Programs for Prevention of Elder Abuse, Neglect, and Exploitation	93.041	460,295
Special Programs for the Aging-Title VII, Chapter 2-Longterm Care Ombudsman Services for Older Individuals	93.042	889,200
Special Programs for the Aging-Title III, Part F-Disease Prevention and Health Promotion Services	93.043	1,791,928
Special Programs for the Aging-Title IV, Training, Research and Discretionary Projects and Programs	93.048	543,016
National Family Caregiver Support	93.052	5,175,742
Food and Drug Administration-Research	93.103	1,350,199
Maternal and Child Health Federal Consolidated Programs	93.110	94,842
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	7,810,464
Grants for Technical Assistance Activities Related to the Block Grant for Community Mental Health Services-Technical Assistance Centers for Evaluation	93.119	61,387
Emergency Medical Services for Children	93.127	99,537
Primary Care Services-Resource Coordination and Development Primary Care Offices	93.130	211,135
Injury Prevention and Control Research and State and Community Based Programs	93.136	144,608
Projects for Assistance in Transition from Homelessness	93.150	4,990,421
Health Program for Toxic Substances and Disease Registry	93.161	841,214
Grants for State Loan Repayment	93.165	911,847
Demonstration Cooperative Agreements for Development and Implementation of Criminal Justice Treatment Networks	93.229	813,350
Consolidated Knowledge Development and Application Program	93.230	23
Traumatic Brain Injury-State Demonstration Grant Program	93.234	27,884
Cooperative Agreements for State Treatment Outcomes and Performance Pilot Studies Enhancement	93.238	425,557
Innovative Food Safety Projects	93.245	10,000
Community Access Program	93.252	630,450
Childhood Immunization Grants	93.268	263,533,328 *
Centers for Disease Control and Prevention-Investigations and Technical Assistance	93.283	3,263,270
Promoting Safe and Stable Families	93.556	43,942,711
Temporary Assistance for Needy Families	93.558	3,201,375,339
Child Support Enforcement	93.563	297,005,475
Refugee and Entrant Assistance-State Administered Programs	93.566	28,168,663
Low-Income Home Energy Assistance	93.568	67,034,045

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Community Services Block Grant	93.569	52,744,816
Community Services Block Grant Discretionary Awards-Community Food and Nutrition	93.571	415,161
Child Care for Families At-Risk of Welfare Dependency	93.574	634,667
Refugee and Entrant Assistance-Discretionary Grants	93.576	6,170,532
U.S. Repatriation	93.579	21,522
Refugee and Entrant Assistance-Targeted Assistance	93.584	7,479,787
Empowerment Zones Program	93.585	138,909
State Court Improvement Program	93.586	913,837
Community-Based Family Resource Centers and Support Grants	93.590	2,394,346
Welfare Reform Research, Evaluations and National Studies	93.595	161,005
Grants to States for Access and Visitation Programs	93.597	1,215,365
Head Start	93.600	221,508
Adoption Incentive Payments	93.603	7,251,678
Developmental Disabilities Basic Support and Advocacy Grants	93.630	5,299,177
Children's Justice Grants to States	93.643	1,119,716
Child Welfare Services-State Grants	93.645	31,020,535
Social Services Research and Demonstration	93.647	173,907
Adoption Opportunities	93.652	302,787
Foster Care-Title IV-E	93.658	1,020,409,929
Adoption Assistance	93.659	212,709,249
Social Services Block Grant	93.667	178,125,103
Child Abuse and Neglect State Grants	93.669	1,703,728
Family Violence Prevention and Services Grants for Battered Women's Shelters-Grants to States and Indian Tribes	93.671	7,376,309
Chafee Foster Care Independent Living	93.674	34,486,945
State Children's Insurance Program	93.767	401,044,515
Medicare-Supplementary Medical Insurance	93.774	5,225,789
Centers for Medicare and Medicaid Services Research, Demonstrations and Evaluations	93.779	859,605
Grants to States for Operation of Offices of Rural Health	93.913	468,292
HIV Care Formula Grants	93.917	108,886,577
Cooperative Agreements for State-Based Comprehensive Breast and Cervical Cancer Early Detection Program	93.919	7,439,403
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938	954,643
HIV Prevention Activities: Health Department Based	93.940	14,478,509
HIV Demonstration, Research, Public and Professional Education Projects	93.941	617,794

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Epidemiological Research Studies of Acquired Immunodeficiency Syndrome (AIDS) and Human Immunodeficiency Virus (HIV) Infection in Selected Population Groups	93.943	589,077
Human Immunodeficiency Virus (HIV)/Acquired Immunodeficiency Virus Syndrome (AIDS) Surveillance	93.944	2,156,655
Assistance Program for Chronic Disease Prevention and Control	93.945	450,982
Demonstration Grants to States with Respect to Alzheimer's Disease	93.951	37
Block Grants for Community Mental Health Services	93.958	43,703,270
Block Grants for Prevention and Treatment of Substance Abuse	93.959	259,406,870
Preventive Health Services-Sexually Transmitted Disease Control Grants	93.977	4,745,095
Preventive Health Services- Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	93.978	1,118,748
Health Program for Refugees	93.987	571,696
Cooperative Agreements for State-Based Diabetes Control Program and Evaluation of Surveillance Systems	93.988	693,496
Preventive Health and Health Services Block Grant	93.991	15,392,236
Maternal and Child Health Services Block Grant to the States	93.994	42,877,882
Other-Department of Health and Human Services	93.999	19,238,542
Total Excluding Clusters		6,435,016,161
Aging Cluster		
Special Programs for the Aging - Title III, Part B - Grants for Supportive Services & Senior Centers	93.044	33,804,639
Special Programs for the Aging - Title III, Part C - Nutrition Services	93.045	49,615,438
Total Aging Cluster		83,420,077
Child Care Cluster		
Child Care and Development Block Grant	93.575	622,725,060
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596	326,093,931
Total Child Care Cluster		948,818,991
Medicaid Cluster		
State Medicaid Fraud Control Units	93.775	14,322,247
State Survey and Certification of Health Care Providers and Suppliers	93.777	31,212,646
Medical Assistance Program	93.778	14,869,813,234
Total Medicaid Cluster		14,915,348,127

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Research & Development Cluster		
Centers for Medicare and Medicaid Services Research, Demonstrations and Evaluations	93.779	320,000
HIV Prevention Activities-Health Department Based	93.940	124,874
Total Research & Development Cluster		444,874
Total U.S. Department of Health and Human Services		22,383,048,230
Corporation for National and Community Service		
State Commissions	94.003	1,918,439
Learn and Serve America-School and Community Based Programs	94.004	2,319,638
AmeriCorps	94.006	28,946,869
Total Excluding Clusters		33,184,946
Foster Grandparent/Senior Companion Cluster		
Foster Grandparent Program	94.011	1,126,357
Total U.S. Corporation for National and Community Service		34,311,303
Social Security Administration		
Disability Insurance/SSI Cluster		
Social Security-Disability Insurance	96.001	177,083,516
Office of National Drug Control Policy		
High Intensity Drug Trafficking Area	See Note 4	3,108,521
Miscellaneous Grants and Contracts		
Shared Revenue-Flood Control Lands	98.002	193,583
Shared Revenue-Grazing Land	98.004	115,671
Capital Outlay-Reed Act	98.012	21,224,307

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
U.S. Department of the Interior-Fire Prevention/Suppression Agreement	98.014	134,000
U.S. Department of the Interior-Fire Prevention/Suppression Agreement	98.015	125,781
U.S. Department of Agriculture and Various Other U.S. Department-Fire Prevention/Suppression	98.016	9,011,507
Miscellaneous Federal Receipts	98.099	176,342
Miscellaneous Federal Receipts	98.999	1,919,832
Total Miscellaneous		32,901,023
Total Federal Awards Received		**$63,277,766,130**

* Amount includes value of commodities or food stamps.

** Amount includes donated property.

*** Amount includes loans and insurance in effect as of June 30, 2002.

NOTES TO THE SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2002

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, 2002. 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 $63,277,766,130 in total federal assistance consists of the following:

Cash assistance received	$38,032,285,207
Noncash federal awards	2,042,966,989
Loans and/or loan guarantees outstanding	20,192,319,976
Insurance in-force	3,010,193,958
Total	**$63,277,766,130**

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 force for the year ended June 30, 2002.

3. UNEMPLOYMENT INSURANCE

Of the $5,225,800,893 in total unemployment insurance funds (federal catalog number 17.225) received by the Employment Development Department during fiscal year 2001-02, $4,840,000,000 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, 2001 through June 30, 2002, 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			
	City of San Diego	2002 I2PSCP575	$ 30,817
		1999 I9PSCP575	29,650
		2000 I0PSCP575	281,906
		2001 I1PSCP575	970,898
	City of Hawthorne	2000 I0PLAP534	270,278
		2001 I1PLAP534	1,158,398
	Washington State Patrol	2001 I1PNWP505	34,875
	County of Stanislaus	2001 I1PCVP501	139,033
	County of San Mateo	2001 11PSFP502	192,666
		Total	$3,108,521

The State was also loaned Federal Excess Personal Property (FEPP) from the U.S. Forest Service during the period July 1, 2001 to June 30, 2002. According to the California Department of Forestry and Fire Protection, the amount loaned from July 1, 2001 to June 30, 2002, was $1,922,514. 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

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SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

Reference Number:	**2001-12-7**
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:	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:	**2001-1-1**
Federal Catalog Number:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Allowable Activities. Although it has procedures in place to ensure that it obtains prior approval from the U.S. Department of Agriculture's Food and Nutrition Service for data-processing project costs exceeding $24,999, the California Department of Health Services does not always adhere to them.
Status of Corrective Action:	Fully corrected.[2]

Reference Number:	**2001-2-2**
Federal Catalog Number:	10.558
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Allowable Costs and Cost Principles. The Department of Education (Education) overpaid a food program sponsor $14,350 because it entered an incomplete claim adjustment into its claim payment system. Additionally, this overpayment increased the sponsor's average monthly

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	reimbursement, which Education uses when calculating the allowable cash advance. As a result, Education overpaid the cash advance to the sponsor by more than $9,550. When we brought these overpayments totaling $23,900 to Education's attention, it recovered the claim and advance overpayments from the sponsor.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-5-1**
Federal Catalog Number:	10.556; 10.559
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Eligibility. The Department of Education could not demonstrate the eligibility for all participants the Bureau of State Audits reviewed in the Special Milk Program for Children and Summer Food Service Program for Children.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-13-2**
Federal Catalog Number:	10.558
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Subrecipient Monitoring. The Department of Education (Education) did not adequately fulfill its subrecipient monitoring responsibilities for the food program.
Status of Corrective Action:	Partially corrected. Education has implemented procedures for pre and post approval review activities to ensure the reviews are conducted within the regulatory requirements. Education requested changes to the database to better monitor the required reviews. This should be completed by December 31, 2002. In the interim, a spreadsheet is used to track large Child and Adult Care Food Program applicants. Education's new file room protocols have effectively eliminated the problem of missing master files. The file maintenance drastically reduced the number of filing errors that existed.[3]

Reference Number:	**2001-14-1**
Federal Catalog Number:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Special Tests and Provisions. The Department of Health Services did not ensure that the financial management systems of all local agencies were examined during monitoring reviews for fiscal years 1999-2000 and 2000-01. Nor did it always promptly notify local agencies of the deficiencies found during these reviews.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-14-2**
Federal Catalog Number:	10.550
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Special Tests and Provisions. The Department of Education (Education) did not fulfill its review responsibilities relating to its in-state food processors. During fiscal years 1999-2000 and 2000-01, Education failed to conduct on-site reviews of 9 of its 25 active in-state processors within the required two-year period. In addition, it reviewed only 24 percent of its active in-state processors during fiscal year 2000-01, rather than the required 50 percent.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-14-6**
Federal Catalog Number:	10.561
State Administering Department:	Department of Social Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Special Tests and Provisions. The California Department of Social Services (Social Services) failed to ensure that all of the counties participating in the Food Stamps program obtained independent reviews. Of the 58 counties, 7 had the physical inventory review performed by their own welfare department, the same department that administers the Food Stamps program. Additionally, Social Services did not require any of the counties to submit review reports for it to analyze; instead, Social Services depended on counties to

self-report review findings, the date of the review, and who performed the review.

Status of Corrective Action: Disagree with finding. Following additional research and review, Social Services does not concur with the finding recommendations. Effective internal audits were conducted by the seven counties cited in the report. The oversight by Social Services in this area includes an annual survey of all counties to determine areas of noncompliance and corresponding audit resolution plans. Additionally, Social Services management evaluation reviews will be conducted onsite in each of the 58 counties at a minimum of every three years.

Regarding the recommendation for Social Services to require all counties to obtain "independent reviews," Social Services staff thoroughly researched the applicable Federal and State regulations and we were unable to find an "independent review" requirement. The Social Service's interpretation of both federal and state regulations is that entities within the county welfare departments (CWD), that have expertise in auditing and accounting and are organized separate and apart from CWD divisions responsible for Food Stamp issuance or Food Stamp storage are permitted to conduct the annual food stamp bulk storage inventory reviews. This separation of function provides an effective internal control to safeguard the accuracy of reviews conducted by the CWD's internal audits unit.

Regarding the recommendation that Social Services require all counties to submit completed annual reports for review, the Social Services has also modified its initial plan. Instead of obtaining seven randomly selected county reports to review each year, the Social Services will conduct an annual survey of all CWDs to determine their compliance with federal and state regulations governing Food Stamp Program bulk storage inventory audits. Additionally, Social Services will conduct onsite reviews of all 58 counties to ensure compliance with these audit requirements within a three-year cycle.[4]

Reference Number: **2001-3-9**

Federal Catalog Number: 10.557; 17.207; 17.225; 17.246; 17.250; 84.126; 93.558; 93.658; 93.659; 93.778

State Administering Department: Department of Finance

Fiscal Year Finding Initially Reported: 2000-01

Audit Finding: Cash Management. The Department of Finance (Finance) requires state departments to report information related to the receipt and disbursement of federal funds of selected federal programs so that it can calculate interest liabilities under the CMIA agreement. However, we found that several

departments submitted administrative cost worksheets for fiscal year 1999-2000 that included receipts or disbursements of federal funds that actually related to fiscal year 2000-01. Although Finance correctly omitted these transactions when calculating interest liabilities associated with administrative costs for fiscal year 1999-2000, it neglected to include these transactions in its fiscal year 2000-01 calculation. As a result of these omissions, Finance calculates that it overstated the State's net interest liability in the fiscal year 2000-01 annual report by nearly $1.1 million.

Status of Corrective Action: Partially corrected. The finding will be fully corrected December 31, 2002. The overpaid $1.1 million in 2000-01 State interest liability will be reported as a prior year adjustment in the fiscal year 2001-02 annual report that will be submitted to the U.S. Department of Treasury in December 2002. This adjustment will reduce the State interest liability that will be paid for fiscal year 2001-02.

Finance will also continue its ongoing efforts to reduce errors by improving internal procedures, analyzing the information reported by state departments, providing ongoing consultation and training, and annually reminding departments of their responsibilities.[5]

Reference Number: **2001-9-6**

Federal Catalog Number: 10.551; 10.561; 93.558; 93.658; 93.659; 93.667

State Administering Department: Department of Social Services

Fiscal Year Finding Initially Reported: 2000-01

Audit Finding: Suspension and Debarment. The Department of Social Services (Social Services) failed to require any of the counties receiving federal funds under the six federal programs reviewed by the Bureau of State Audits (BSA) to submit the required suspension and debarment certifications. Additionally, for the Adoption Assistance program, Social Services did not obtain certifications from two of the three contractors reviewed by the BSA from which Social Services contracted services totaling $100,000 or more.

Status of Corrective Action: Fully corrected.

Reference Number:	**2001-13-1**
Federal Catalog Number:	10.557; 93.917; 93.994
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	1998-99
Audit Finding:	Subrecipient Monitoring. The Department of Health Services lacks an adequate system to ensure that it promptly receives all audit reports from nonprofit subrecipients required to submit them. It also lacks an adequate system to ensure that it issues management decisions on reported findings.
Status of Corrective Action:	Fully corrected (10.557). Partially corrected (93.917). The Department of Health Services, Office of AIDS (OA) contracts now include language requiring subrecipients to submit OMB A-133 audit reports when required, and certifications when an OMB A-133 audit is not required. The OA formed a division wide workgroup to identify OMB A-133 audit procedures for all federally funded OA contracts. OA's HIV Care Branch programs have implemented and included these procedures in their desk reference manuals. In addition to procedures, audit reminder form letters have been developed to send to subrecipients according to a tracking schedule. The HIV Care Branch staff log and monitor audit reminder letters and any follow-up and/or corrective action(s) in an audit-tracking database. A small portion of HIV CARE Formula Grant funds is included in contracts monitored by other OA division branches. Division-wide implementation of OMB A-133 audit procedures, to include all OA federally funded contracts, is scheduled to begin by 12/31/02. OA and DHS, Audits and Investigations Section have discussed appropriate procedures and responsibilities for receipt and review of OMB A-133 audit reports. Fully corrected (93.994).[6]

Reference Number:	**2001-9-7**
Federal Catalog Number:	14.239
State Administering	Department of Housing and Community Development
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Suspension and Debarment. The Department of Housing and Community Development does not require subrecipients of HOME Investment Partnerships Program funds to submit suspension and debarment certifications.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-2-1**
Federal Catalog Number:	17.207; 17.225; 17.255; 17.801; 17.804; 17.253; 84.278
State Administering Department:	Employment Development Department
Fiscal Year Finding Initially Reported:	1998-99
Audit Finding:	Allowable Costs and Cost Principles. The Employment Development Department lacked documentation supporting the basis of its allocation for some of its payroll and operating costs charged to federal programs.
Status of Corrective Action:	Fully corrected.[7]

Reference Number:	**2001-9-1**
Federal Catalog Number:	20.205
State Administering Department:	Department of Transportation
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Procurement, Suspension, and Debarment, Special Tests and Provisions. The California Department of Transportation (Caltrans) could not always locate its contract files or other documents needed to show that it complied with certain federal requirements for its highway construction projects.
Status of Corrective Action:	Partially corrected. Caltrans is continuing to improve its system of tracking contract files and other documents for highway construction projects, as well as ensure that the contract files are complete. Caltrans efforts include the following: • Additional filing space has been obtained and a file shelving system was procured in the prior fiscal year. • A business process review of the filing system is completed in draft form and has been distributed for division review and comment. • The filing backlog resulting from vacancies and inadequate filing space has been significantly reduced with the use of overtime and workload redistribution within the clerical support unit. • The lack of Federal Highways Administration (FHWA) written concurrence with one Contract Change Order (CCO) was caused by a misunderstanding of FHWA approval requirements. Caltrans clarified the Construction Manual CCO approvals section. Caltrans also developed a "CCO Course" that provides instructions on FHWA approval requirements and Resident Engineers have completed training in this course.

- The lack of support for testing on material and workmanship for two of ten projects is an issue of inadequate controls over records. In July 2001, field office staff were trained *on Field Office Procedures for Statewide Consistency*, which should aid in improving controls over records of testing materials and workmanship.[8]

Reference Number:	**2001-8-1**
Federal Catalog Number:	83.544
State Administering Department:	Office of Emergency Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Period of Availability. The Office of Emergency Services (Emergency Services) cannot ensure that the services it is paying for are within the allowable time period.
Status of Corrective Action:	Partially corrected. The Emergency Services, Disaster Assistance Division (DAD) fiscal year 2002-03 work plans include initiating grant payment review for open and material sub-grantees. In addition, DAD executive management has initiated a complete review of its current organizational structure to more closely align unit functions with a grant management concept. Finally, Emergency Services will consider redirecting additional resources, if available, after possible current and budget year cuts, to manage this workload.

Reference Number:	**2001-9-5**
Federal Catalog Number:	83.544; 83.548
State Administering Department:	Office of Emergency Services
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Suspension and Debarment. The Office of Emergency Services (Emergency Services) did not require Public Assistance Grants and Hazard Mitigation Grant program applicants to submit suspension and debarment certifications.
Status of Corrective Action:	Partially corrected. As described in the prior audit *Department's View and Corrective Action Plan*, Emergency Services is in the process of developing a grant management system. This system will establish a more routine review of subrecipients to ensure that they have complied with applicable grant laws and regulations, including not entering into agreements with any parties who are debarred, suspended, or otherwise excluded from participation in federal assistance programs. Additionally,

Emergency Services will consider adding a link on its web page to the Federal Excluded Parties Listing System website, which would provide easy subrecipient access to debarred, suspended or otherwise excluded parties.[9]

Reference Number:	**2001-12-4**
Federal Catalog Number:	83.544; 83.548
State Administering Department:	Office of Emergency Services
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Reporting. The Office of Emergency Services' (Emergency Services) financial status reports contain unsupported expenditure information.
Status of Corrective Action:	Uncorrected. In the last year, Emergency Services has not been successful in meeting with Federal Emergency Management Agency (FEMA) for obtaining guidance on the reporting problems relating to grant and administrative expenditures. It is our intention to submit a written request to FEMA outlining our questions and issues by the end of the 2002 calendar year.[10]

Reference Number:	**2001-12-5**
Federal Catalog Number:	83.544; 83.548
State Administering Department:	Office of Emergency Services
Fiscal Year Finding Initially Reported:	1997-98
Audit Finding:	Reporting. In fiscal year 2000-01, the Office of Emergency Services (Emergency Services) did not reconcile the receipts and disbursements reported in its federal cash transaction reports to its official accounting records.
Status of Corrective Action:	Uncorrected. Emergency Services has not reconciled the receipts and disbursements reported in the federal cash transaction reports to our official accounting records. Emergency Services does not have staff to redirect that possesses the level of expertise required to perform these technical functions. Also, Emergency Services is not able to request additional positions for the current fiscal year. It is Emergency Services' intention to comply with the Bureau of State Audits' recommendation with existing staff as workload permits.[11]

Reference Number:	**2001-13-3**
Federal Catalog Number:	83.544; 83.548
State Administering Department:	Office of Emergency Services
Fiscal Year Finding Initially Reported:	1996-97
Audit Finding:	Subrecipient Monitoring. During fiscal year 2000-01, the Office of Emergency Services did not have a system in place to ensure that its nonprofit subrecipients spending more than $300,000 in federal funds submitted required audit reports.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-2-3**
Federal Catalog Number:	84.011
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Allowable Costs and Cost Principles. The Department of Education did not always determine the cost-effectiveness of the State's use of Migrant Education funds.
Status of Corrective Action:	Fully corrected.[12]

Reference Number:	**2001-3-2**
Federal Catalog Number:	84.181
State Administering Department:	Department of Developmental Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Cash Management. The Department of Developmental Services (Developmental Services) did not always minimize the amount of time elapsing between the transfer of Early Intervention federal funds to the State and their disbursement for program costs.
Status of Corrective Action:	Uncorrected. The Developmental Services continues to acknowledge that the time between receipt and the disbursement of federal funds is not always minimized. Further, the Developmental Services has attempted additional measures to try and expedite the claim schedules through the California State Controller's Office (SCO). However, Developmental Services notes that claim schedules not falling under the guidelines of the Cash Management Improvement Act (CMIA), will not receive special handling without paying an additional SCO processing fee. Developmental Services contacted several

other departments who are also not covered by the CMIA, and found that they are in the same situation. Developmental Services will continue to look for new ways to minimize the time between receipt and disbursement.[13]

Reference Number:	**2001-3-3**
Federal Catalog Number:	84.011; 84.181; 84.340
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients minimize the time elapsing between their receipt and use of federal program funds.
Status of Corrective Action:	Partially corrected. Education implemented procedures in the Special Education and Class Size Reduction programs that provide the Local Education Agencies (LEAs) an initial advance based on their grant award, and the next payment to be based on an interim expenditure report submitted by the LEAs. The Migrant Education program has reduced the amount of advances given to the LEAs and will work with the county and district superintendents on adjusting the next payment based on the interim expenditure reports. It is anticipated changes to the Migrant Education program will be made by July 1, 2003. All three Education programs added an additional reporting field to the expenditure report requesting the amount of interest earned over $100.[14]

Reference Number:	**2001-3-5**
Federal Catalog Number:	84.126
State Administering Department:	Department of Rehabilitation
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Cash Management. The Department of Finance (Finance) requires state departments to report information related to the receipt and disbursement of federal funds so that it can calculate the State's interest liability under the Cash Management Improvement Act agreement. However, a review of the worksheets used in the calculation of the interest liability revealed an error in a formula in the first-quarter worksheet sent to Finance by the Department of Rehabilitation.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-3-7**
Federal Catalog Number:	84.186
State Administering Department:	Department of Alcohol and Drug Programs
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Cash Management. The Department of Alcohol and Drug Programs (Drug and Alcohol) lacks adequate procedures to ensure that subrecipients of the Safe and Drug-Free Schools program minimize the time elapsing between receipt and use of program funds.
Status of Corrective Action:	Fully corrected. Effective with the federal fiscal year 2002 Safe and Drug-Free Schools and Communities grant award, the department will not be making monthly payments to counties regardless of their actual expenditures. Counties will be submitting invoices, and Drug and Alcohol will then reimburse the counties for actual costs incurred.[15]

Reference Number:	**2001-3-8**
Federal Catalog Number:	84.048; 84.243
State Administering Department:	California Community Colleges, Chancellor's Office
Fiscal Year Finding Initially Reported:	1997-98
Audit Finding:	Cash Management. The California Community Colleges, Chancellor's Office does not have adequate procedures to ensure that subrecipients of the Vocational Education—Basic Grants to States program and the Tech-Prep Education program minimize the time elapsing between their receipt and use of federal program funds.
Status of Corrective Action:	Fully corrected.[16]

Reference Number:	**2001-5-2**
Federal Catalog Number:	84.126
State Administering Department:	Department of Rehabilitation
Fiscal Year Finding Initially Reported:	1996-97
Audit Finding:	Eligibility. The Department of Rehabilitation (Rehabilitation) does not always determine applicant eligibility for the Vocational Rehabilitation program within the required time period.
Status of Corrective Action:	Partially corrected. Rehabilitation continues to take proactive steps through a collaborative effort with district administrators and rehabilitation supervisors in ensuring

	timely and appropriate eligibility determinations. Rehabilitation has partially completed the corrective actions as reported in the prior audit *Department's View and Corrective Action Plan* and has plans to complete the remaining corrective actions.[17]
Reference Number:	**2001-9-3**
Federal Catalog Number:	84.048
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Suspension and Debarment. The Department of Education did not obtain the required suspension and debarment certifications from six of eight contractors reviewed.
Status of Corrective Action:	Fully corrected.
Reference Number:	**2001-9-4**
Federal Catalog Number:	84.010; 84.340
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Suspension and Debarment. The Department of Education needs to improve its procedures for obtaining the required suspension and debarment certifications.
Status of Corrective Action:	Fully corrected.[18]
Reference Number:	**2001-12-2**
Federal Catalog Number:	84.010; 84.011
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Reporting. The Department of Education did not report the correct average daily attendance in its 1999 fiscal report.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-12-3**
Federal Catalog Number:	84.048
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Reporting. The Department of Education did not report accurate, complete, and supported data in its Vocational Education performance accountability report.
Status of Corrective Action:	Fully corrected.[19]

Reference Number:	**2001-14-3**
Federal Catalog Number:	84.010; 84.011
State Administering Department:	Department of Education
Fiscal Year Finding Initially Reported:	1998-99
Audit Finding:	Special Tests and Provisions. The Department of Education (Education) did not require local educational agencies (LEAs) receiving Migrant Education and Title I, Part A funds to file with Education a specific written assurance stating that the LEAs have established and implemented an LEA-wide salary schedule; a policy to ensure equivalence among schools in teachers, administrators, and other staff; and a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies.
Status of Corrective Action:	Partially corrected. Education included a new assurance regarding comparability as part of the 2002-03 Consolidated Application, which Local Educational Agencies (LEA) are currently completing. The Superintendent or authorized representative for each LEA certifies to these assurances when the LEA submits Part I of the Consolidated Application. Additionally, in a letter dated August 8, 2000, Education reminded the districts of their obligations under Title I, Part A Section 1120 (c)(2,3,4,5). And, on June 17, 2002, the U.S. Department of Education (USDE) assigned a staff person to respond to Education's request concerning the expectation for monitoring this effort. However, Education has not received any information or a response from the USDE.[20]

Reference Number:	**2001-8-2**
Federal Catalog Number:	84.186; 93.959
State Administering Department:	Department of Alcohol and Drug Programs
Fiscal Year Finding Initially Reported:	1999-00 (84.186); 2000-01 (93.959)
Audit Finding:	Period of Availability. The Department of Alcohol and Drug Programs lacks adequate procedures to ensure that federal grant awards are obligated and spent within their applicable periods of availability.
Status of Corrective Action:	Fully corrected.[21]

Reference Number:	**2001-3-1**
Federal Catalog Number:	93.917
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Cash Management. The Department of Health Services did not always minimize the amount of time elapsing between the transfer of federal funds to the State and the funds' disbursement for program costs.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-3-4**
Federal Catalog Number:	93.568
State Administering Department:	Department of Community Services and Development
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Cash Management. The Department of Community Services and Development did not always minimize the amount of time elapsing between the transfer of federal funds to the State and the funds' disbursement for Low-Income Home Energy Assistance program costs.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-3-6**
Federal Catalog Number:	93.658
State Administering Department:	Department of Social Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Cash Management, Reporting. The Department of Social Services overstated its disbursements by more than $1 million and understated its cash on hand by the same amount for its Foster Care program on the federal cash transaction report to the federal government.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-7-1**
Federal Catalog Number:	93.994
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Earmarking. The Department of Health Services does not have adequate procedures to ensure that it meets the program's earmarking requirements.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-7-2**
Federal Catalog Number:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Matching. The Department of Health Services (Health Services) does not always apply the correct federal rate for Medicaid claims. Specifically, for $582.6 million in claims filed during fiscal year 2000-01 for services provided between October 1, 2000, and June 30, 2001, Health Services applied a rate of 51.67 percent rather than the approved rate of 51.25 percent.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-9-2**
Federal Catalog Number:	93.268; 93.917; 93.994
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	1998-99
Audit Finding:	Suspension and Debarment. The Department of Health Services did not always obtain the required suspension and debarment certifications from its subrecipients during fiscal year 2000-01.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2001-12-1**
Federal Catalog Number:	93.994
State Administering Department:	Department of Health Services
Fiscal Year Finding Initially Reported:	1999-00
Audit Finding:	Reporting. The Department of Health Services (Health Services) does not always report complete information in its annual program report to the U.S. Department of Health and Human Services. Specifically, Health Services does not identify and explain that it estimated some of the expenditures and other amounts in its annual report.
Status of Corrective Action:	Fully corrected.[22]

Reference Number:	**2001-12-6**
Federal Catalog Number:	93.568
State Administering Department:	Department of Community Services and Development
Fiscal Year Finding Initially Reported:	2000-01
Audit Finding:	Reporting. In its January 2001 report to the U.S. Department of Health and Human Services, the Department of Community Services and Development did not accurately report for the Low-Income Home Energy Assistance program the number of households it served during the federal fiscal period covering October 1, 1999, through September 30, 2000, and the demographics of these households.
Status of Corrective Action:	Fully corrected.[23]

Reference Number: **2001-14-4**

Federal Catalog Number: 93.778

State Administering Department: Department of Health Services

Fiscal Year Finding Initially Reported: 1997-98

Audit Finding: Special Tests and Provisions. The Department of Health Services (Health Services) does not have adequate controls over provider agreements.

Status of Corrective Action: Partially corrected. Health Services concurs with the finding and has instituted the following activities to help resolve these issues:

- Initiated preliminary discussions with the Licensing and Certification Program to incorporate provider agreements into the acute care enrollment process. These discussions will continue to ensure implementation.
- The impending passage of Assembly Bill 2010, which requires a consolidated application form for licensure of clinics, concurrent enrollment as a MediCal provider, and enrollment in specified Health Services programs, will further promote the consistent collection of required provider agreements from all providers.
- Continue the re-enrollment process so that provider agreements and/or disclosure of significant beneficial interest are reasonably current. This process now prioritizes higher risk providers. Health Services has re-enrolled approximately 600 providers and has deactivated approximately 900 providers.
- Perform mass deactivation of providers that have not billed services for 12 months.[24]

Reference Number: **2001-14-5**

Federal Catalog Number: 93.778

State Administering Department: Department of Health Services

Fiscal Year Finding Initially Reported: 1997-98

Audit Finding: Special Tests and Provisions. When calculating the payment rates effective August 2001 for long-term care facilities that treat developmentally disabled individuals (LTC facilities), the Department of Health Services (Health Services) audited far fewer cost reports than it would have audited had it followed its established methodology.

Status of Corrective Action: Uncorrected. Disagree with finding. Health Services disagrees with the finding that it did not audit the number of cost reports as required by the state plan's provisions and according to its past practices. The state plan for long term

care reimbursement, 4.19-D, Section III, Audits, subsection A states in part, " . . . a minimum of 15 percent of cost report will be field audited by the Department of each year. Facilities identified for audit shall be selected on a random sample basis, except where the entire universe of a class is selected for audit." The plan does not specify any particular sampling technique. A straight 15 percent sample of the facilities in question would have produced a sample of 128, far less than the number actually audited.

While Health Services audited fewer cost reports than what was selected, Health Services believes that it complied with the state plan. Specifically, Health Services audited 15 percent of the population of cost reports, and believes that the state plan can be interpreted to mean that a 15 percent sample is sufficiently large enough to reasonably expect audit results and a class audit adjustment factor representative of the class of facilities for which it will be used during the annual rate-setting process. Moreover, the number of cost reports actually audited (146 cost reports), as opposed to the sample size selected (395 cost reports) is significantly higher than the number of cost reports audited in previous years.

In addition, the class audit adjustment for the one type of LTC facility derived from the sample question was .96550, whereas the class audit adjustment for the previous year was .93852. The class audit adjustment for the other type of facility derived from the sample in question was .94601, whereas the class audit adjustment for the previous year was .94603. Therefore, Health Services maintains, the adjustments derived from the sample in question were within reason. Notwithstanding the above, Health Services is committed to revising, based on the concerns identified in the audit, the language in the state plan addressing the sampling methodology for the selection of facilities to be field-audited. A study is now underway to present alternatives to the current long-term care reimbursement system. Such a change will require a complete revision of the state plan, including audits.

ENDNOTES—AUDITOR COMMENTS

[1] The status of this issue remains unchanged. Please refer to reference number 2002-12-1 for additional information.

[2] We reported a similar weakness during our audit of fiscal year 2001-02. Please refer to reference number 2002-2-2 for additional information.

[3] We reported a similar weakness during our audit of fiscal year 2001-02. Please refer to reference number 2002-13-4 for additional information.

[4] We reviewed the status of this issue during our audit of fiscal year 2001-02 and confirmed that the U.S. Department of Agriculture agrees that the county welfare departments may conduct these reviews when the State has delegated the review responsibility to the counties. We also noted that Social Services has included a review of the food stamps bulk storage inventory reports during its onsite visits to evaluate the counties' management of the Food Stamps program. However, we were unable to review the counties' self reporting of the results of their inventory reviews because Social Services had not requested these reports until January 2003.

[5] Although the specific errors reported in this finding were fully corrected, we reported a similar weakness during our audit for fiscal year 2001-02. Please refer to reference number 2002-3-7 for additional information.

[6] We reported a similar weakness during our audit of fiscal year 2001-02. Please refer to reference number 2002-13-5 for additional information.

[7] The Employment Development Department has developed better documentation to support its allocation of costs charged to federal programs, but it still does not adjust these charges to reflect actual activity. Therefore, we reported a similar weakness for these programs in our audit of fiscal year 2001-02. Please refer to reference number 2002-2-3 for additional information.

[8] We reviewed the status of this issue during our fiscal year 2001-02 audit and found a similar, though less severe, condition. We reported this weakness during our audit of fiscal year 2001-02. Please refer to reference number 2002-9-2 for additional information.

[9] Emergency Services did not contract with new subrecipients in fiscal year 2001-02. Consequently, we were unable to verify whether it is obtaining suspension and debarment certifications from its subrecipients.

[10] We reported a similar weakness for these programs in our audit of fiscal year 2001-02. Please refer to reference number 2002-12-3 for additional information.

[11] We reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-12-2 for additional information.

[12] We reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-2-1 for additional information.

[13] During fiscal year 2001-02, we found no reportable issues at the Department of Developmental Services concerning this specific issue. However, we found that the claims payment and cash drawdown process used by the State does not always limit transfers of federal funds to the immediate cash needs for those federal grants not covered by the Cash

Management Improvement Act Agreement. Please refer to reference number 2002-3-8 for additional information.

[14] We reviewed the status of this finding during our audit of fiscal year 2001-02 and found no reportable issues in the Special Education—Infants and Families with Disabilities and Class Size Reduction programs. However, Education has not fully implemented adequate procedures to ensure that its subrecipients in the Migrant Education program minimize the time elapsing between their receipt and use of program funds. Therefore, we reported a similar weakness for this program during our audit of fiscal year 2001-02. Please refer to reference number 2002-3-10 for additional information.

[15] We reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-3-4 for additional information.

[16] We reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-3-2 for additional information.

[17] We reported a similar weakness during our audit of fiscal year 2001-02. Please refer to reference number 2002-5-1 for additional information.

[18] Although Education modified the legal assurances for its consolidated application for fiscal year 2002-03 to include the suspension and debarment certification, it had not implemented procedures to obtain these certifications from its subrecipients for fiscal year 2001-02. Therefore, we reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-9-6 for additional information.

[19] We reported a similar weakness during our audit for fiscal year 2001-02. Please refer to reference number 2002-12-6 for additional information.

[20] Although Education modified the legal assurances for its consolidated application for fiscal year 2002-03 to include the comparability certification for the Title I Grants to Local Educational Agencies, it had not implemented procedures to obtain these certifications from its subrecipients for fiscal year 2001-02. In addition, Education has not modified the legal assurances for the Migrant Education—Basic State Grant Program. Thus, we reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-14-4 for additional information.

[21] We reviewed the status of this issue during our audit of fiscal year 2001-02 and found that, although DADP did not have a reportable issue for the Safe and Drug-Free Schools and Communities—State Grants program, it had not yet completely resolved the issues that we reported during our audit of fiscal year 2000-01 for expenditures incurred outside the periods of availability. In addition, we found that DADP did not always ensure that charges to federal awards for the Substance Abuse Prevention and Treatment Block Grant program are within each award's period of availability. Therefore, we reported a similar weakness for this program for fiscal year 2001-02. Please refer to reference number 2002-8-1 for additional information.

[22] Although Health Services added new footnotes and text to its annual report explaining that some of the amounts are based on estimates, it did not disclose that other amounts are also based on estimates. Therefore, we reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-12-7 for additional information.

[23] We reviewed the status of this issue during our audit of fiscal year 2001-02 and found that Community Services and Development had not yet fully implemented adequate procedures to ensure that it accurately reports the number of households it served and the demographics of these households in its Low-Income Home Energy Assistance household report. Therefore, we reported a similar weakness for this program. Please refer to reference number 2002-12-8 for additional information.

[24] Health Services has completed only part of its efforts to re-enroll providers of Medicaid services. Therefore, we reported a similar weakness in our audit of fiscal year 2001-02. Please refer to reference number 2002-14-5 for additional information.

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

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

March 12, 2003

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 Year Ended June 30, 2002

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, 2002, and will be part of the Single Audit Report covering this period. We accept the reported findings and recommendations. Although our internal controls and administration of federal awards can always be improved, the State is committed to sound and effective fiscal oversight.

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

In meeting our responsibility for financial leadership and oversight, the Department of Finance conducts internal control reviews of State departments and also reviews areas of potential weakness in the State's fiscal systems. In addition, we provide oversight of departmental internal audit units by issuing audit guidelines and conducting quality assurance reviews. Further, we have an ongoing process of issuing Audit Memos to departments that establish statewide policy and provide technical advice on various audit related issues. We will soon issue an Audit Memo concerning the results of the fiscal year 2001-02 Single Audit.

The head of each State department is responsible for establishing and maintaining a system of internal accounting and administrative control within their department. This responsibility includes documenting the system, communicating system requirements to employees, and assuring that the system is functioning as prescribed and is modified for changing conditions.

Moreover, all levels of State management must be involved in assessing and strengthening their system of internal accounting and administrative controls to minimize fraud, errors, abuse, and waste of government funds.

Individual departments have separately responded to the report's findings and recommendations. Accordingly, their viewpoints and corrective action plans are included in the report. We will monitor the findings and reported corrective actions to identify potential changes in statewide fiscal procedures.

The Department of Finance will continue to provide leadership to ensure the proper financial operations and business practices of the State, and to ensure that internal controls exist for the safeguarding and effective use of assets and resources.

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

Sincerely,

KATHRYN RADTKEY-GAITHER
Assistant Director for Budget and Operations

for

STEVE PEACE
Director