



# State of California

Internal Control and Compliance Audit Report  
for the Fiscal Year Ended June 30, 2013

Report 2013-001.1



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May 27, 2014

2013-001.1

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

Dear Governor and Legislative Leaders:

As required by California Government Code, Section 8543 et seq., the California State Auditor presents this audit report concerning our review of the State of California's internal controls and compliance with state laws and regulations for the year ended June 30, 2013.

This report concludes that the State continues to experience certain deficiencies in its accounting and administrative practices that affect its internal controls over financial reporting and compliance with state laws. We identified four deficiencies in internal control over financial reporting that we consider to be material weaknesses, and one other deficiency that we consider to be significant. Additionally, we identified an instance of noncompliance that is required to be reported under *Government Auditing Standards*. Deficiencies in the State's internal control system could adversely affect its ability to provide accurate financial information.

Respectfully submitted,



JOHN F. COLLINS II, CPA  
Deputy State Auditor

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**Independent Auditor's Report on Internal Control  
and on Compliance and Other Matters**

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

The Governor and the Legislature of the State of California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California as of and for the year ended June 30, 2013, and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated April 16, 2014. Our report includes a reference to other auditors who audited the financial statements of the following, as described in our report on the State's financial statements:

### ***Government-wide Financial Statements***

- Certain enterprise funds that, in the aggregate, represent 86 percent of the assets and deferred outflows and 32 percent of the revenues of the business-type activities.
- The University of California and the California Housing Finance Agency that represent 93 percent of the assets and deferred outflows, and 92 percent of the revenues of the discretely presented component units.

### ***Fund Financial Statements***

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, State Lottery fund, and California State University fund.
- The Golden State Tobacco Securitization Corporation, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control, and the 1943 Veterans Farm and Home Building funds, that represent 85 percent of the assets and deferred outflows, and 51 percent of the additions, revenues, and other financing sources of the aggregate remaining fund information.
- The discretely presented component units noted above.

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Lottery, the Water Resources, and the 1943 Veterans Farm and Home Building funds were not audited in accordance with *Government Auditing Standards*.

### **Internal Control Over Financial Reporting**

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

May 2014

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be material weaknesses—items 2013-3 through 2013-6.

A significant deficiency is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be a significant deficiency—item 2013-2.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of California's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that are required to be reported under Government Auditing Standards. It is presented in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as item 2013-1.

The State of California's responses to the findings identified in our audit are described in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. The State's responses were not subjected to the auditing procedures applied in the audit and, accordingly, we express no opinion on them.

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

CALIFORNIA STATE AUDITOR



JOHN F. COLLINS II, CPA  
Deputy State Auditor

April 16, 2014

## **Schedule of Findings**

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**STATE OF CALIFORNIA  
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2013**

**Summary of Auditor's Results**

***Financial Statements***

Type of auditor's report issued	Unmodified
Internal control over financial reporting:	
Material weaknesses identified?	Yes
Significant deficiency identified that is not considered to be a material weakness?	Yes
Noncompliance material to financial statements noted?	No

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

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## CALIFORNIA COMMUNITY COLLEGES CHANCELLOR'S OFFICE

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Reference Number: 2013-1

### Condition

The California Community Colleges Chancellor's Office (Chancellor's Office) authorized \$48.5 million in general apportionments to three community college districts that were not entitled to receive such amounts between fiscal years 2005–06 and 2011–12. In fiscal year 2012–13, the Chancellor's Office stopped distributing general apportionment funding to districts that do not meet the criteria set forth in the Education Code. However, it has not recovered the \$48.5 million in general apportionments that it paid to the three community college districts without explicit legal authority.

Community college districts receive apportionment funding primarily from three sources: property taxes, student fees, and the State's General Fund. Where local property taxes and student fees alone do not meet a district's apportionment target, the General Fund provides additional funding, referred to as general apportionments, to each district. The Chancellor's Office calculates each district's general apportionment annually based on criteria set forth in the Education Code, including data on student enrollment and local revenues. Districts that have local property tax and student fee revenues that exceed their apportionment target are not entitled by law to receive general apportionment funding from the State. These districts are known as excess tax school entities, or basic aid districts.

Between fiscal years 2005–06 and 2011–12, revenues for three of the State's 72 community college districts—Mira Costa, Marin, and South Orange—exceeded their apportionment target. However, while these districts did not meet the criteria set forth in the Education Code to receive general apportionment funding, the Chancellor's Office authorized such funding for each of those seven years. Annually, these amounts ranged from \$3 to \$8.7 million between fiscal years 2005–06 and 2011–12.

When we first reported a finding on this issue (i.e., fiscal year 2010–11), the Director of Fiscal Services of the Chancellor's Office (director) stated that the Chancellor's Office authorized a portion of general apportionment funding to the three districts each year between fiscal year 2005–06 and 2010–11 to compensate for their loss of Partnership for Excellence funding. The Partnership for Excellence Program, created by Senate Bill 1564 in 1998, provided supplemental funding until January 1, 2005, to community colleges for the purposes of achieving annual performance goals and improving student learning and success. The text that authorized Partnership for Excellence funding was not included in budget acts subsequent to fiscal year 2004–05. The director stated that for fiscal year 2005–06, the Department of Finance provided budget-related documents to the Chancellor's Office showing an increase in general apportionment funding that matched the amount previously provided through the Partnership for Excellence Program. He further explained that because net funding did not change, the Chancellor's Office interpreted the increase in general apportionment funding as a reclassification of funding that was not intended to reduce funding to basic aid districts. However, the Chancellor's Office could not demonstrate that it sought a legal opinion to support its decision to authorize general apportionment funding to basic aid districts after the expiration of Partnership for Excellence funding.

In addition, the Chancellor's Office did not present these payments as general apportionments in the state apportionment reports it publishes on its Web site. Instead it reported them as "Partnership" in fiscal year 2005–06, "other base entitlement" in fiscal year 2006–07, and as "other adjustments" for fiscal years 2007–08 through 2011–12. For this reason, it has not been clear to the public that the three districts have effectively received general apportionment funding. By allocating general apportionment funding to basic aid districts, the amount of funding available for the remaining 69 community college districts was reduced by \$48.5 million between fiscal years 2005–06 and 2011–12.

## Criteria

The following criteria were in effect during fiscal years 2005–06 through 2011–12:

Education Code Section 84328 requires the Board of Governors of the California Community Colleges to certify each apportionment made by it to the State Controller's Office.

Revenue and Taxation Code Section 95 states that an "excess tax school entity" means an educational agency for which the amount of the state funding entitlement determined under Education Code sections 2558, 42238, 84750 or 84751, as appropriate, is zero.

Education Code Section 84751 provides the methodology used in determining each community college district's revenue level for each fiscal year.

## Recommendations

To ensure that community college districts that rely on general apportionment funding receive their entitled amounts, the Chancellor's Office should recover \$48.5 million in general apportionments paid to the Mira Costa, Marin, and South Orange community college districts, and redistribute these monies to the remaining community college districts.

## Department's View and Corrective Action Plan

The Chancellor's Office disagrees that the prior payments should be recovered from the community college districts. It believes that the prior payments were made due to a reasonable administrative interpretation of the situation for the following reasons:

- Basic aid districts received the Partnership for Excellence payments directly as a categorical program for many years.
- Provisional language included in the 2004 Budget Act made clear the direction to continue payments to basic aid districts (as similarly provided for other districts) for that fiscal year.
- There was no funding reduction in the subsequent fiscal year that indicated intent to eliminate payments to the basic aid districts.

The Chancellor's Office interpreted that continuation of funding in the context of the 2004 Budget Act language as intent to permanently continue the funding for all districts, including basic aid districts.

When the Legislative Analyst's Office brought the Partnership for Excellence funding of basic aid districts to the attention of the Legislature in the spring of 2011, legislative staff communicated to the Chancellor's Office an inclination to discontinue the payments to basic aid districts. This led to a reexamination of the practice and the subsequent phasing out of payments to basic aid districts. As indicated above, as of fiscal year 2012–13, the Chancellor's Office stopped distributing general apportionment funding to basic aid districts.

The Chancellor's Office believes that compelling the Mira Costa, Marin, and South Orange Community College Districts to repay funds allocated over a number of prior years due to a revision in understanding of earlier legislative intent would create a hardship for those districts. Rather, it believes its solution to deal with the issue prospectively represents satisfactory corrective action.

## Auditor's Comments on the Chancellor's Office's View

The Chancellor's Office authorized \$48.5 million in general apportionments to three community college districts that were not entitled to receive such amounts between fiscal years 2005–06 and 2011–12. Consequently, the amount of funding available for the remaining 69 community college districts was reduced by this amount. We continue to believe that the Chancellor's Office should recover the \$48.5 million in general apportionments paid to the Mira Costa, Marin, and South Orange community college districts, and redistribute these monies to the remaining community college districts.

## DEPARTMENT OF DEVELOPMENTAL SERVICES

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Reference Number: 2013-2

### Condition

The Department of Developmental Services (DDS) significantly understated its General Fund liabilities for fiscal year 2012–13. Specifically, DDS failed to accrue \$227 million of accounts payable owed to regional centers for services they provided during fiscal year 2012–13. In accordance with the Welfare and Institutions Code, the State enters into five-year contracts with regional centers to provide services to individuals with developmental disabilities, subject to annual appropriations of funds by the Legislature. These contracts specify the amount allocated to each of the five fiscal years covered by the contracts. However, DDS did not estimate and record a liability for services performed, but not invoiced, by these regional centers during fiscal year 2012–13. After we pointed out this error, DDS submitted an appropriate adjustment to the State Controller's Office (Controller's Office) to record this \$227 million liability.

In addition, DDS overstated expenditures in fiscal year 2011–12 by not reestablishing an accrual for reimbursements related to the prior fiscal year. In fiscal year 2012–13, DDS received these reimbursements which had the effect of understating current year expenditures. Consequently, DDS agreed that it was necessary for the Controller's Office to make an adjustment for \$232 million to increase its beginning General Fund balance and current year expenditures to correct this misstatement.

### Criteria

California Government Code Section 12461 requires the Controller's Office to issue an annual financial report that is prepared in accordance with generally accepted accounting principles (GAAP). The Controller's Office provides guidance to departments on the preparation of their year-end financial statements in its Year-End Financial Reports Information GAAP Basis Manual. To prepare its financial report, the Controller annually requests that departments submit GAAP-related information for the funds they manage.

Codification of Governmental Accounting and Financial Reporting Standards Section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. The current financial resources measurement focus and modified accrual basis of accounting require an expenditure and liability to be recorded when the liability has been incurred and when it will be paid with current financial resources.

### Recommendation

To ensure its financial statements are properly presented at fiscal year-end, DDS should revise its procedures to report expenditures, including reimbursements, and liabilities for all the governmental funds it manages on the modified accrual basis.

### Department's View and Corrective Action Plan

DDS has corrected the financial statements for fiscal year 2012–13 to address the audit findings above.

In addition, DDS has set up year-end processes to accrue reimbursements and regional center contract balances in the first year of the appropriation and adjust these accruals to reflect unrealized reimbursements and unliquidated contract balances in each of the subsequent open years of the appropriations. DDS will use common state accounting practices to identify the estimated reimbursements and expenditures in each year that it accrues these amounts.

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## DEPARTMENT OF HEALTH CARE SERVICES

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Reference Number: 2013-3

### Condition

The Department of Health Care Services (DHCS) understated Medi-Cal expenditures and revenues for fiscal year 2012–13 in the Federal Trust Fund by \$865.9 million and \$1.8 billion, respectively. Additionally, DHCS understated Medi-Cal expenditures and revenues for fiscal year 2012–13 in the Public Hospital Investment, Improvement, and Incentive Fund and the Hospital Quality Assurance Revenue Fund by \$357.2 million and \$82.5 million, respectively. For budgetary purposes, DHCS reports Medi-Cal expenditures on a cash-basis. Generally accepted accounting principles (GAAP), however, require governmental funds to be accounted for on a modified accrual basis. Specifically, expenditures should be recognized in the accounting period in which they are incurred. As a result, DHCS must prepare GAAP adjustments to convert its budgetary reports to the modified accrual basis for proper presentation in the State's Comprehensive Annual Financial Report. The following sections provide more detail about DHCS' understatements by program.

### Understated Accruals for the Specialty Mental Health Consolidation and the Delivery System Reform Incentive Pool Programs

DHCS understated expenditures and related revenues by \$426.2 million in the Federal Trust Fund for the Specialty Mental Health Consolidation program (Mental Health program), which provides specialty mental health services for MediCal recipients that meet medical necessity criteria. Additionally, DHCS understated expenditures and related revenues by \$357.2 million in the Federal Trust Fund and \$357.2 million in the Public Hospital Investment, Improvement, and Incentive Fund for the Delivery System Reform Incentive Pool (Incentive Pool) program, which supports California's Designated Public Hospitals' efforts by providing federal funds for four program areas. These areas include infrastructure development, innovation and redesign, population-focused improvement, and urgent improvement in care.

The understatements occurred because DHCS used a flawed accrual methodology, calculating its accruals based only on the portion of expenditures it had estimated it would pay out by June 30, 2013. These estimates did not cover expenditures for services provided by June 30 that DHCS expected to pay in the following fiscal year. According to the employee in the DHCS Accounting Section responsible for compiling the Medi-Cal accrual, DHCS operates on a cash basis during the fiscal year and the resulting accrual estimates were based on the difference between DHCS's budgeted spending authority and the amounts it had paid as of June 30, 2013. As discussed above, GAAP requires the use of the modified accrual basis of accounting for governmental funds. By not accruing Medi-Cal expenditures and related revenues as required by GAAP, DHCS risks materially misstating the Medi-Cal related expenditures and revenues it reports.

### Understated Accruals for the Hospital Quality Assurance Fee—Hospital Payments program

DHCS also understated its Hospital Quality Assurance Fee—Hospital Payments (Hospital Payment) program expenditure and related revenue accruals by approximately \$82.5 million each in the Hospital Quality Assurance Revenue Fund. Additionally, DHCS understated expenditures and related revenues for this program in the Federal Trust Fund by \$82.5 million and \$1 billion, respectively. Welfare and Institutions Code Section 14169.32 imposes a quality assurance fee on hospitals in order to obtain additional federal funding for supplemental payments to hospitals and for payments for children's healthcare costs. For the Hospital Payment Program, DHCS collects quality assurance fees from hospitals, matches these fees to federal funding for the program, and then disburses both quality assurance fee revenues and federal funding back to hospitals as Medi-Cal payments. DHCS relied heavily on estimates when calculating the managed care portion of its Hospital Payment program accruals although actual data on related billings was available. It submitted invoices to hospitals in mid-August 2013 for managed care quality assurance fees related to the prior fiscal year. For the last two fiscal years, 2011–12 and 2012–13,

DHCS has ultimately received about 96 percent of the billed amounts. As such, the actual billed amount adjusted by a historical collection rate offers a more reliable basis for preparing the accrual than the estimate calculated by the Quality Assurance Fund Unit. In this case, DHCS billed \$677.8 million and collected \$658.9 million or \$82.5 million more in quality assurance fees than its accrual for fiscal year 2012–13 of \$576.4 million. Because DHCS matches these fees with federal funds it also understated Federal Trust Fund expenditures by the same amount. Additionally, DHCS failed to accrue corresponding Federal Trust Fund revenues for the Hospital Payment program. These revenues amounted to about \$1 billion. According to the employee in the Accounting Section responsible for compiling the Medi-Cal accrual, DHCS omitted the Federal Trust Fund revenues from the Hospital Payment program accruals by mistake. We found that DHCS' process for developing the Hospital Payment program accrual omitted the creation of accounting entries related to Federal Trust Fund revenues. Without a complete process to guide its staff in preparing the accruals, DHCS risks materially misstating Medi-Cal accruals in the future.

### Criteria

California Government Code Section 12461 requires the State Controller's Office (Controller's Office) to issue an annual financial report that is prepared in accordance with GAAP. To prepare its financial report, the Controller's Office annually requests that departments submit GAAP-related adjustments for the funds they manage.

Governmental Accounting and Financial Reporting Standards Section 1600 states that financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. The current financial resources measurement focus and modified accrual basis of accounting require expenditures to be recorded when a liability has been incurred and when it will be paid with current financial resources.

The Controller's Office provides guidance to departments on the preparation of their year-end financial statements in its Year-End Financial Reports Information GAAP Basis Manual (GAAP manual). According to the GAAP manual, agencies should accrue liabilities and related expenditures for services provided prior to June 30 that will be paid in the following fiscal year.

### Recommendation

To ensure its financial statements are properly presented at fiscal year-end, DHCS should:

- Report activity for all the governmental funds it manages on a modified accrual basis.
- Use actual data, when available, in the development of accruals.
- Develop a process to ensure it accrues all revenues related to the Hospital Payment program.

### Department's View and Corrective Action Plan

Recommendation 1: DHCS agrees with the recommendation. Beginning with the next State fiscal year 2013–14, DHCS will report activity for all governmental funds under its management on a modified accrual basis. DHCS states it has begun drafting desk procedures that will provide instructions to current and future staff detailing how to produce a fiscal year end accrual using the modified accrual methodology.

Recommendation 2: DHCS agrees with the recommendation. Beginning with the next State fiscal year 2013–14, DHCS will use actual data in the development of its accruals. DHCS states it has begun a process of identifying the actual data and providing the staff responsible for the accrual development access to the needed data sources. DHCS will draft desk procedures that contain accrual reporting instructions which identify all the actual data sources and the related contacts for obtaining the actual data.

Recommendation 3: DHCS agrees with the recommendation. Beginning with the next State fiscal year 2013–14, DHCS states it has developed a process to ensure it accrues all revenues related to the Hospital Payment program.

## DEPARTMENT OF TRANSPORTATION

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Reference Number: 2013-4

### Condition

In its fiscal year 2012–13 financial statements, the Department of Transportation (Caltrans) incorrectly reported balances related to the State’s capital assets. Specifically, it reported to the State Controller’s Office (Controller’s Office) capital asset balances containing a net overstatement of about \$900 million resulting from three separate errors.

The first error involved Caltrans’ improper recognition of certain highway construction project costs as infrastructure assets. Under generally accepted accounting principles, Caltrans should record infrastructure additions and improvements as assets only if they increase an infrastructure asset’s capacity or efficiency. Infrastructure additions and improvements that do not meet this criterion should be expensed as maintenance costs. During our audit of the fiscal year 2011–12 financial statements, we identified that Caltrans had inappropriately recorded the cost of two toll bridge seismic retrofit projects as infrastructure assets instead of as expenses, resulting in an overstatement of capital assets. Upon further investigation we recognized that Caltrans might have additional projects erroneously recorded as infrastructure, so we asked Caltrans to identify and analyze any other infrastructure projects that could cause its records to be misstated.

Caltrans produced two separate analyses of its infrastructure, one for potentially overstated projects and one for potentially understated projects. Its overstatement analysis identified categories of infrastructure assets containing projects that potentially should not have been recorded as assets. We tested projects in the identified categories and found that only the categories described as “seismic retrofit” contained project costs that should not have been recorded as assets. In total, these categories contained about \$228 million of capital assets that should have been expensed as maintenance costs. Caltrans’ understatement analysis identified regional projects that were never recorded as assets but potentially should have been. We tested the four largest identified projects and found that all four should have been recorded as assets, resulting in about \$1.4 billion of unreported capital assets.

The second error involved Caltrans’ improper reporting of infrastructure additions on its fiscal year 2012–13 financial statements. This resulted primarily from two significant errors. Caltrans overstated its infrastructure account balance by \$1.2 billion due to the misapplication of adjusting entries meant to eliminate certain costs from the capital asset additions it reports. It also overstated its infrastructure work in progress account balance by \$1.1 billion when it erroneously double-posted capital asset additions for one of its funds. It appears Caltrans could have avoided these errors by performing a more thorough review of its financial statements.

The third error involved Caltrans’ failure to record and report two building projects that it received ownership of in fiscal year 2012–13. The Department of General Services (General Services) constructs buildings on behalf of state departments and upon project completion sends a notice to the department receiving the asset. The notice says that the department is required to record and report the asset. In fiscal year 2012–13, General Services completed construction of two building projects worth about \$199 million on Caltrans’ behalf and sent completion notices to Caltrans. Caltrans received the notices but did not correctly record or report the assets, resulting in an understatement of capital assets.

At fiscal year-end the Controller’s Office gathers information on the State of California’s capital assets from state departments and presents it in the Comprehensive Annual Financial Report (CAFR). When departments incorrectly report capital assets to the Controller’s Office, it can cause the CAFR’s capital asset balances to be misstated. Left uncorrected, Caltrans’ capital asset errors would have been large enough to cause significant misstatements. We therefore communicated the errors we identified

to Caltrans. It corrected its fiscal year 2012–13 financial reports for the infrastructure-related errors noted and indicated it would adjust its fiscal year 2013–14 financial information to correct the error related to buildings.

### Criteria

Sections 1400.105 through 108 of the Governmental Accounting and Financial Reporting Standards apply to governments using the modified approach for reporting infrastructure assets. These sections allow a government to avoid depreciating its infrastructure assets as long as it maintains them at or above a condition level established and disclosed by the government. California uses this approach in accounting for its state highway system. It therefore expenses all costs used to maintain its infrastructure assets and only records costs as capital assets if they have increased the capacity or efficiency of the infrastructure system.

The *State Administrative Manual*, sections 7463, 7977 and 8660, requires state departments to report in their financial statements to the Controller's Office all additions and deductions to capital assets. The Controller's Office uses these reports to compile the information related to capital assets that it presents in the CAFR.

### Recommendations

Caltrans should improve its processes for recording infrastructure costs. Specifically, its policies and procedures should allow it to, on an ongoing basis, properly identify and segregate infrastructure costs that it should record as expenses from infrastructure costs that it should record as capital assets.

To ensure that its financial statements do not contain significant errors, Caltrans should improve its process for reviewing the capital asset reports it submits to the Controller's Office. The process could include an analytical procedure that would compare capital asset amounts between the current year and the prior year to determine if current year amounts are reasonable.

Caltrans should develop procedures to ensure that it records and reports all capital assets it owns at fiscal year-end.

### Department's View and Corrective Action Plan

Caltrans procedures have relied on coding structures for State Transportation Improvement Program and State Highway Operation and Protection Plan capital projects for purposes of distinguishing capital improvements that should be recorded as infrastructure costs and expenses. Caltrans will perform an in-depth evaluation of this approach and revise its procedures to ensure infrastructure is capitalized correctly. Additionally, Caltrans will incorporate analytical comparisons into its procedures to validate infrastructure reporting is reasonable when compared to prior year reporting. Finally, Caltrans will enhance its procedures to ensure it records as capital assets completed building construction.

## DEPARTMENT OF TRANSPORTATION

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Reference Number: 2013-5

### Condition

The Department of Transportation (Caltrans) made significant errors in reporting its fiscal year 2012–13 financial information for the State Highway Account to the State Controller’s Office (Controller’s Office), and ultimately submitted required adjustments to the Controller’s Office late. If uncorrected, the errors would have caused the material misstatement of business and transportation expenditures and accounts receivable in the State’s Transportation Fund at June 30, 2013.

Effective fiscal year 2011–12, the Department of Finance (Finance) requires Caltrans to report its State Highway Account financial information on a cash basis for budgetary purposes. As a result, Caltrans must prepare generally accepted accounting principal (GAAP) adjustments dissimilar to those it historically submitted to convert its budgetary reports to the modified accrual basis for proper presentation in the State’s Comprehensive Annual Financial Report (CAFR). According to the Chief of Caltrans’ Office of Financial Accounting and Analysis, Caltrans’ initial calculations of GAAP adjusting entries contained errors because written procedures were not updated to reflect the new reporting requirements. Caltrans’ initial calculations incorrectly produced a modified accrual adjustment to expenditures of negative \$591.9 million. The adjustment, if calculated correctly, would normally record additional expenditures related to services received by fiscal year-end that are expected to be paid in the subsequent year. The erroneous GAAP adjustment resulted in a \$1.5 billion understatement of fiscal year 2012–13 business and transportation expenditures for the State Highway Account. This error, if uncorrected, would have been significant enough to cause a material misstatement of the Transportation Fund, one of the four major governmental funds presented in the State’s CAFR. In a related GAAP adjustment, Caltrans also materially overstated its accounts receivable, submitting a GAAP adjustment of \$1.6 billion. A portion of Caltrans’ expenditures are normally reimbursed by others, leading to the recording of accounts receivable. For fiscal year 2012–13, Caltrans’ gross overaccrual of its accounts receivable resulted in a \$1.4 billion overstatement of this account. Subsequent to our inquiry, Caltrans calculated that the correct State Highway Account GAAP adjustment for expenditures should have been \$880.1 million and that the correct adjustment for accounts receivable should have been \$205.6 million. It submitted these adjustments to the Controller’s Office on February 13, 2014.

### Criteria

California Government Code Section 12461 requires the Controller’s Office to issue a CAFR that is prepared in accordance with GAAP. To prepare the financial report, the Controller’s Office annually requests that departments submit GAAP-related adjustments for the funds they manage. The Controller’s Office’s “Year-End Financial Reports Information—GAAP Basis” manual represents the Controller’s Office’s guidance to departments regarding GAAP adjustments. Specifically, the Controller’s Office requires departments to accrue liabilities and related expenditures for unpaid services received prior to fiscal year-end that are expected to be paid within the next year. State Administrative Manual Section 7950 requires departments to prepare year-end reports soon after June 30 to meet the required due dates and to estimate accruals with reasonable accuracy. For fiscal year 2012–13, GAAP adjustments were due to the Controller’s Office September 3, 2013.

The aforementioned guidelines are designed in part to ensure compliance with the requirements of the Governmental Accounting and Financial Reporting Standards Section 1600, which requires that financial statements for governmental funds be presented using the current financial resources measurement focus and modified accrual basis of accounting. The current financial resources measurement focus and the modified accrual basis of accounting require expenditures to be recorded when a liability has been incurred and when it will be paid with current financial resources.

**Recommendation**

To ensure the accurate and timely submission of financial information for the State Highway Account to the Controller's Office, Caltrans should update its written procedures to guide its efforts in calculating required GAAP adjustments and reporting them in a timely manner to the Controller's Office.

**Department's View and Corrective Action Plan**

As the State Auditor indicates, the requirement to report State Highway Account activity on a cash basis was implemented to correctly align budgetary basis financial statements with Governor's Budget reporting, and resulted in a significant change in accounting practices for the State Highway Account. Caltrans had a great deal of communication with the Controller's Office regarding the fiscal year 2012–13 financial statement reporting for the State Highway Account. These communications continued beyond the financial statement reporting deadlines, and the procedures to be followed, including the calculation of the GAAP adjustments, were not easily determined. Caltrans will update its written procedures to be used for fiscal year 2013–14 for calculation of GAAP adjustments for the State Highway Account, and will seek concurrence from Controller's Office staff regarding the procedures.

## STATE CONTROLLER'S OFFICE

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Reference Number: 2013-6

### Condition

The State Controller's Office (Controller's Office) did not perform the necessary level of due diligence to prevent and detect errors that if uncorrected would have caused the material misstatement of the State's Comprehensive Annual Financial Report (CAFR). Specifically, the Controller's Office implemented new accounting standards without sufficiently determining the impact of those standards on the CAFR. In addition, the Controller's Office improperly implemented a new process for developing entries to reverse prior year accruals, which resulted in multiple inaccurate entries. The Controller's Office also posted numerous inaccurate adjusting entries for current year activity because its staff followed desk procedures that were outdated or inadequate to guide them in performing their duties. Furthermore, we determined that the Controller's Office lacked a sufficient internal review process. Specifically, we found multiple instances of obvious misstatements that should have caused the Controller's Office to question whether an error had been made, including excessive understatements of liabilities and improperly reporting negative account balances. Finally, the Controller's Office submitted multiple note disclosures that contained significant errors in account balances and other required information. It is important to note that the Controller's Office's State Government Reporting Bureau within its Division of Accounting and Reporting, which is responsible for producing the CAFR, experienced significant turnover over the last three fiscal years. Specifically, from fiscal year 2009–10 to fiscal year 2012–13, the turnover rate for the bureau's staff was 30 percent. More significantly, the turnover rate for the bureau's middle managers and supervisors, who are responsible for reviewing staff work products, was 75 percent during this period. Similarly, the turnover rate for the division's upper managers who are responsible for supervising the bureau, including the division chief, an assistant division chief, and a bureau chief, was 100 percent. These high turnover rates likely contributed to a number of the issues described in this finding.

### The Controller's Office Struggled to Effectively Implement New Standards

The Controller's Office did not always perform adequate due diligence when implementing five new standards in fiscal year 2012–13 that were issued by the Governmental Accounting Standards Board (GASB). We had several common concerns with the Controller's Office's implementation of these standards. Specifically, it did not begin to implement these new standards until the very latter part of fiscal year 2012–13, and in some cases did not finalize its implementation of these standards until early 2014 when our audit was nearly complete. In addition, the Controller's Office did not always gather sufficient evidence or perform effective analyses to determine the appropriate and complete impact of these new standards on the CAFR. Consequently, we sometimes had to perform our own analyses to determine how these new standards affected the accounting and reporting of certain types of transactions. Although these implementation deficiencies did not result in significant errors for four of the five new standards, the Controller's Office's efforts to implement one standard were particularly problematic.

Specifically, the GASB issued Statement Number 65 (GASB 65), Items Previously Reported as Assets and Liabilities, which establishes standards that reclassify certain items that were previously reported as assets and liabilities as deferred outflows of resources and deferred inflows of resources. Although GASB specified that this standard is effective for periods beginning after December 15, 2012, the Controller's Office chose to early implement it for fiscal year 2012–13. However, the Controller's Office did not send us its initial draft approach for implementing GASB 65 until May 2013, and it did not finish analyzing all of the potential effects of GASB 65 until March 2014. In the interim, the Controller's Office sent us numerous transmittals that included various analyses of the affects of GASB 65 on different types of transactions. However, it did not always gather sufficient evidence to support its

conclusions, sometimes relying primarily on e-mail assertions from agencies. The Controller's Office's inadequate assessment of the effects of GASB 65 would have resulted in significant misstatements and a flawed disclosure if uncorrected as discussed in subsequent sections of this finding.

### **The Controller's Office Made Material Errors When It Reversed Prior Year Accruals**

The Controller's Office prepared numerous erroneous reversing entries and posted these entries to its accounting system that if uncorrected would have caused the material misstatement of the State's financial statements. Initially, the Controller's Office understated Federal Trust Fund revenues and expenditures by \$7.7 billion; it overstated General Fund assets and revenues by \$653 million; and it overstated the revenues and expenditures or transfers out of the Non Major Governmental Funds by \$1.7 billion. These errors also impacted the Governmental Activities in the Government-wide financial statements, which were also affected by an additional error that overstated liabilities and expenditures by \$1.0 billion. Properly prepared adjusting entries are needed in specific instances to ensure the State's financial statements comply with applicable reporting standards. In the following year the Controller's Office must reverse those entries that represent prior year accruals to avoid the double reporting of activity; once when the underlying transaction occurs and then again when the cash is received or disbursed. However, the Controller's Office erroneously reversed several adjusting entries that did not represent prior year accruals, and failed to reverse other entries that did represent prior year accruals.

These errors occurred partly due to the improper implementation of a new process intended to assist in identifying prior year accruals; coupled with existing desk-procedures governing their reversal. Specifically, in fiscal year 2012–13 the Controller's Office implemented the use of an automatically generated excel-worksheet. This worksheet was populated with all the adjusting entries posted in the prior year for staff to analyze and identify those entries in need of reversal. However, this automated worksheet omitted the information needed to determine whether an adjusting entry was in fact an accrual that needed to be reversed. In particular, it did not list each individual transaction, but instead consolidated all transactions with the same document number into one entry. The Controller's Office assigns document numbers to track adjusting entries. Each numbered document may contain more than one transaction to address multiple objectives, which are described within the related "description" field. However, during the consolidation process, the description for the first transaction was applied to all of the transactions sharing the same document number in some cases, and in other cases this description was omitted altogether. Therefore the Controller's Office could not accurately identify which entries to reverse using this report.

Additionally, the Controller's Office's desk procedures governing this task are not adequate to guide staff in the performance of their duties. Specifically, the Controller's Office's desk procedures require that staff reverse any prior year adjusting entries impacting both a balance sheet and income statement account. Even though the prior year accruals meet this definition, these procedures do not explain or require staff to understand the purpose of these entries. As a result, the Controller's Office cannot be sure staff accurately select and reverse all appropriate adjusting entries. Additionally, while staff are required to reconcile beginning fund balance in order to ensure all reversing entries have been identified, the Controller's Office's procedures do not address the type of situation when the accrual includes the equal recognition of both revenues and expenditures, and therefore has no impact on fund balance, such as is generally the case for entries in the Federal Trust Fund. In fact the Federal Trust Fund experienced the greatest number of errors and had the most sizable misstatements related to reversing entries as previously mentioned.

### **The Controller's Office Improperly Prepared Numerous Current Year Adjusting Entries**

The Controller's Office also prepared numerous erroneous adjusting entries related to current year activity, and posted these entries to its accounting system. Specifically, we noted a significant increase in the volume of adjusting entries, some of which can be explained. However, a large portion represents entries the Controller's Office inappropriately prepared and the multiple attempts to correct the resulting errors. These errors occurred because of the Controller's Office's failure to update

its procedures to adjust to current circumstances, including the implementation of new standards. These weaknesses over financial reporting could result in material misstatements in future financial statements, if not corrected by the Controller's Office.

For example, the Controller's Office posted an excessive amount of adjusting entries prepared by multiple individuals to the Economic Bond Recovery Sinking Fund, a Non Major Governmental debt service fund. In the prior year, the State began accruing principal and interest payments scheduled within 30 days after fiscal year-end in the budgetary basis financial statements, which is appropriate. However, given the presentation differences between the budgetary basis and generally accepted accounting principles (GAAP) basis the Controller's Office needed to prepare a GAAP entry to reclassify the budgetary basis accrual from Accounts Payable to Interest Payable and General Obligation Bonds Payable. It also needed to reclassify the budgetary basis General Government expenditures related to debt service to Debt Service expenditures for GAAP, as it did in the prior year. However, the Controller's Office incorrectly reversed the prior year reclassification entry and caused the misstatement of \$550 million in the impacted accounts for reasons discussed in the previous section. It then prepared and posted an adjusting entry erroneously accruing \$624 million in debt service expenditures already accrued on the budgetary basis. This error occurred because the Controller's Office's desk procedures had not been updated to reflect the fact that the entry is now posted as a budgetary basis accrual. To correct these errors three different staff prepared and posted a series of nine adjusting entries.

Similarly, outdated desk procedures governing the Trial Court Operations Fund instructed Controller's Office staff to prepare and post an unneeded adjusting entry reclassifying Transfers In to Intergovernmental Revenue, and therefore, would have resulted in overstated revenues and understated transfers of \$780 million. Specifically, the Controller's Office did not update its procedures to address a change in how the operations fund receives funding from the Trial Court Trust Fund. The operations fund reports the cost of trial court operations. The trust fund transfers money it receives from counties and other sources to the operations fund to assist in the funding of these costs. In the prior year, the administering department reported the county support as a transfer between these two funds. Therefore, the Controller's Office prepared and posted an adjusting entry that reclassified this support to Intergovernmental Revenues in the operations funds. In the current year, the department provided financial statements that reflected the proper classification of the county support making the adjusting entry posted by the Controller's Office unnecessary.

Additionally, the Controller's Office failed to update its desk procedures to ensure compliance with GASB standards. For example, in regards to GASB Statement Number 54 (GASB 54), Fund Balance Reporting and Governmental Fund Type Definitions, the Controller's Office posted an entry that would have understated the existing fund balance restrictions by \$678 million for the Financing for Local Governments and the Public fund, a Non Major Special Revenue Fund. GASB 54 requires the classification of fund balance based upon the level of constraint imposed upon funding sources. Restricted fund balance represents the highest level of constraint; however, the standard does not permit the reporting of negative restrictions. Therefore, if fund liabilities exceed assets an entry is needed to reclassify the resulting negative fund balance as unassigned. The Controller's Office posted such an entry for this fund even though it did not have negative restrictions.

Similarly, the Controller's Office failed to update its procedures related to the implementation of GASB 65 for the Golden State Tobacco Securitization Fund. The Controller's Office annually prepares adjusting entries for the Golden State Tobacco Securitization Fund to convert the fund's statements from the accrual basis of accounting to the modified accrual basis of accounting, as required for proper presentation in the fund financial statements. Due to its improper implementation of GASB 65 and outdated procedures, the Controller's Office prepared entries that improperly reported \$532.6 million in deferred outflows of resources that under the modified basis of accounting should not be reported in the fund financial statements. Additionally, the Controller's Office failed to record \$56 million in proceeds from bond premiums and understated debt service expenditures by \$600 million.

Moreover, we found that the Controller's Office initially understated the beginning balance of net position in the Government-wide financial statements for Governmental Activities by \$634 million, which it incorrectly attributed to GASB 65 adjustments related to the refunding of general obligation bonds. However, we determined that these transactions should only have resulted in a reclassification of prior years' refunding gains and losses to deferred inflows of resources and deferred outflows of resources, respectively, and should not have resulted in a restatement of beginning net position. We provided the Controller's Office with guidance on how to correct this error.

### **The Controller's Office Lacked a Sufficient Review Process**

The number and magnitude of errors we found indicate the Controller's Office lacks a sufficient review process to prevent and detect significant errors. For example, the Controller's Office could have prevented a \$365 million understatement to the workers compensation liability and related expenditure accounts by performing a more robust review of its staff's work product. Specifically, the Controller's Office accrued a \$46 million workers compensation liability rather than the correct amount of \$411 million because staff relied on a report that included a keying error. The report provided to us did not contain any evidence the Controller's Office had verified the total liability by summing the columns, or that management had reviewed this information for accuracy. Furthermore, since the workers compensation liability has not been less than \$300 million for any year within the last 10 years, the insignificance of the initial accrual should have caused a reviewer to question whether an error had been made.

Additionally, we found multiple instances of the Controller's Office reporting improper negative account balances. We believe such obvious misstatements should have been a strong indicator of a possible error. For example, the errors for the Golden State Tobacco Securitization Fund, previously discussed, resulted in the reporting of negative debt service expenditures of \$292 million. In another example, the Controller's Office reported a negative \$171.7 million in Due From Other Funds for the Self-Help Housing Fund (a component within the Financing for Local Governments and the Public fund). This error occurred because four different staff posted a series of five duplicate and erroneous adjusting entries in an attempt to simply reduce Due From Other Funds and various liability accounts for budgetary basis transactions that do not represent valid assets or liabilities on a GAAP basis. Finally, the Controller's Office also reported negative Deferred Revenues of \$6.2 billion when its staff posted an entry with three additional zeros when reclassifying advanced tax collections.

### **The Controller's Office Inaccurately Prepared Required Disclosures**

The CAFR prepared by the Controller's Office also includes certain note disclosures as required by GAAP. The Controller's Office's process for submitting note disclosures includes submitting a draft of the disclosure (transmittal) to the California State Auditor's Office (Auditor's Office) after staff prepare the transmittal and a supervisor reviews and approves it. The Controller's Office submitted multiple transmittals, signed and approved by supervisors, to the Auditor's Office with significant errors.

For example, the Controller's Office submitted certain transmittals that contained errors related to the implementation of GASB 65. Specifically, the Controller's Office incorrectly disclosed the reclassification of a previous loss on refunding related to the Golden State Tobacco Securitization Corporation bonds as fiscal year 2012–13 activity, displaying it as a deduction in the governmental activities portion of the schedule of changes in Note 10, instead of as a restatement of the beginning balance. GASB 65 states that a loss on the sale of refunding bonds does not represent an obligation, but instead meets the definition of a deferred outflow of resources. It also specifies that any changes in accounting principle resulting from this definition should be applied retroactively. As a result, the Controller's Office should reflect a change resulting from the implementation of GABS 65 as a restatement of the beginning balance, not as activity of the current fiscal year.

In another example, the Controller's Office reported incorrect revenue bond outstanding balances for three funds in the business-type activities portion of the Schedule of Revenue Bonds Outstanding in Note 16. Specifically, it switched the balances between the Water Resources Fund, the Public Building Construction Fund and the California State University. As a result, the Controller's Office understated the Public Building Construction Fund by \$9.1 billion, and overstated the California State University and Water Resources Fund's Revenue Bonds Outstanding by \$8 billion and \$1.1 billion, respectively. The Controller's Office also incorrectly disclosed the amount of the future debt service in the Schedule of Debt Service Requirements for Revenue Bonds. Specifically, it consolidated the amounts of the future debt service payments for years 2029–2038 into one row instead of separating the debt service payments for this time period into 5-year increments as required by GASB. By consolidating the future debt service payments, the Controller's Office overstated total debt service requirements for 2029–2033 by \$1 billion, and understated 2034–2038 by the same amount in its transmittal. Finally, the Controller's Office omitted an issuance of Enhanced Tobacco Settlement Asset-backed bonds used to refund a portion of the outstanding series 2005A bonds in its Note 16 disclosures.

### Criteria

California Government Code Section 12460 requires the Controller's Office to annually issue two financial reports; each adhering to separate accounting principles. The first, the State's Budgetary/Legal Basis Annual Report, conforms to the Governor's Budget and the Budget Act; and serves as the starting point for the CAFR, the second report. The CAFR must conform to GAAP. When the budgetary basis rules differ from those of GAAP the Controller's Office (or applicable department) must prepare adjusting entries to bring the financial statements into compliance with GAAP. For instance, if the budgetary basis rules require the recognition of revenues or expenditures on a cash-basis, adjusting entries are needed to accrue certain transactions under GAAP. To prepare its financial report, the Controller's Office annually requests that departments submit GAAP-adjusting entries for the funds they manage. However, it is the Controller's Office's responsibility to reverse these accruals in the following fiscal year. In certain limited instances, the Controller's Office prepares additional adjusting entries to ensure the department entries are in compliance with GAAP.

The Controller's Office has established desk procedures to guide its staff in preparing the CAFR. Additionally, the Controller's Office is responsible for designing, implementing, and maintaining processes relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error. An independent audit conducted in accordance with generally accepted auditing standards does not act as a substitute for the maintenance of internal controls necessary for the preparation and fair presentation of financial statements by management.

The National Council on Governmental Accounting Statement Number 1, Section 157 specifies that notes to the financial statements are essential for fair presentation at the general purpose financial statements level and narrative explanations are useful in providing an understanding of combining and individual fund and account group statements and schedules.

GASB Statement Number 38 requires governments to disclose debt service requirements for principal and interest to maturity, presented separately, for each of the five subsequent fiscal years and in five-year increments thereafter.

GASB 54 requires governments to report fund balance for governmental funds in classifications that comprise a hierarchy based primarily on the extent to which the government is bound to honor constraints on the specific purposes for which amounts in those funds can be spent. GASB 54 also prohibits governments from reporting negative restricted, committed, or assigned fund balances in any fund.

GASB 65 states that the difference (e.g. gains and losses) resulting from a current refunding of debt, or an advance refunding of debt, reported by governmental activities, business-type activities, and proprietary funds, relates to future periods and, therefore, meets the definition of a deferred inflow of resources or deferred outflow of resources, as applicable. Additionally, GASB 65 states that accounting

changes adopted to conform to the provisions of the statement should be applied retroactively by restating the financial statements, if practical, for all periods presented. If restatement is not practical, the cumulative effect of applying this statement, if any, should be reported as a restatement of beginning net position or fund balance, as appropriate, for the earliest period restated.

### Recommendations

To effectively implement new standards, the Controller's Office should:

- Develop sound methodologies for implementing new accounting standards in the year prior to their effective date, whenever feasible. This is particularly important for complex standards like GASB 65.
- Provide specific implementation instructions to agencies and obtain any information including supporting documentation that the Controller's Office needs to properly assess the impact of new standards on the CAFR.
- Update its internal procedures to effectively address changes in accounting standards, as necessary.
- Develop effective procedures that ensure that all material impacts on the CAFR are considered when implementing new accounting standards. This should include a methodology for identifying all accounts and types of transactions that could potentially be affected by a new standard and any agencies with material activity.

To ensure the CAFR is properly presented at fiscal year-end, the Controller's Office should:

- Develop a more formal process for reviewing and approving entries before posting them into its GAAP accounting system.
- Develop a process to review financial statements after entries are posted to ensure the accuracy of account balances.
- Develop a process to evaluate its desk procedures annually and update them as necessary.
- Develop and implement proper controls to thoroughly evaluate the effectiveness of any newly developed procedures.
- Provide guidance and training to staff to ensure they understand key accounting concepts and the purpose of the tasks they perform.

### Department's View and Corrective Action Plan

#### *Executive Summary*

The State Controller's Office (SCO) acknowledges that it needs to strengthen its processes regarding the implementation of new standards, reversing and adjusting entries, reviewing staff work, and preparing required disclosures to the financial statements. It should be noted, however, that the Controller received an unmodified opinion or unqualified opinion on the financial statements for fiscal year 2012–13, as it has each year over the past ten years. The SCO concurs with the California State Auditor's (CSAs) notation and believes that the challenges of high staff turnover and in recruiting qualified staff significantly contributed to the issues identified. Other contributing factors included budget cuts and denial of financial resources, as well as poor quality and late submission of the financial data by numerous agencies. For fiscal year 2012–13, at least 178 financial statements required revisions. In addition, 111 statements were submitted late. The substandard, inaccurate, and late statement submissions delayed the start of the CAFR tasks and caused additional work to be performed, thereby, reducing the amount of resources available for SCO staff to complete the expected workload within the planned timeline.

The SCO agrees with the CSA's recommendations regarding implementing new standards and preparing the Comprehensive Annual Financial Report (CAFR), and began taking the appropriate actions by:

- Hiring additional staff in the Policy/Quality Assurance unit and contracting with an external accounting firm with governmental accounting standards expertise to provide additional resources and guidance in the implementation of new accounting standards;
- Working more closely with State agencies to ensure that they are aware that they are responsible for providing and retaining documentation to support their responses and assertions regarding new accounting standards;
- Requiring staff to review and update desk procedures for the fiscal year 2012–13 CAFR by April 25, 2014 and, also, requiring that any changes to tasks or procedures be memorialized within 30 days of the change. The SCO also will add a requirement that the Policy/Quality Assurance unit must update existing desk procedures for any new standards as soon as the impact of a new standard can be determined.
- Developing an additional quality assurance review process to ensure that desk procedures are updated timely;
- Providing more one-on-one and group training to ensure that all staff understand the CAFR tasks to be performed;
- Adopting more stringent and robust analysis and review requirements by using an internal reviewer checklist to further aid in the review of the CAFR tasks, and requiring reviewers to use the Government Finance Officers Association (GFOA) disclosure checklist to ensure that financial statement disclosures are accurate and adequate; and
- Initiating a third-level review of staff work, as needed, relative to the complexity of each task, to ensure that work performed is accurate, until staff are fully trained.

In addition, based on its own internal review of the CAFR process and discussions with staff, the SCO will pursue the following actions:

- Create core courses that all staff who perform CAFR tasks must attend to ensure that staff members possess the necessary governmental accounting knowledge and expertise;
- Continue the SCO's annual open house and expand the effort with a focus on those State agencies that submit late or incorrect statements and reports;
- Create a presentation for State departments so that they understand the importance of submitting correct financial statements as well as the significance and magnitude of the CAFR on the State's ability to conduct business;
- Explore with the Department of Finance (DOF) the possibility of increasing the number and frequency of State fund accounting courses being offered to State agencies;
- Continue to pursue with California Department of Human Resources (CalHR), an SCO- specific accounting classification with appropriate compensation, and commensurate with the work to be performed. The SCO also will explore using recruitment and retention bonuses as an option;

- Follow-up with the agencies that submit late, incorrect, and/or inconsistent reports by performing site visits. Currently, Government Code Section 12461.2 allows the Controller to withhold operating funds for an agency that submits late year-end financial reports. The SCO will explore the possibility of modifying the Government Code to allow the Controller to also withhold the agency or department director's salary until the financial statements are submitted properly;
- Contact the DOF to explore the possibility of changing the required due dates of year-end financial reports. Beginning with the fiscal year 2013–14 report submissions, the SCO will post on the SCO website, a list of agencies that submit late reports; and
- Explore the possibility of introducing new, or changing existing legislation, to adhere more closely to a GAAP-based standard.

These proposals and actions are discussed in more detail later in this document.

### **SCO Response**

The SCO acknowledges the issues raised by the CSA and is in process of implementing appropriate actions to correct the concerns noted. Annually, the State Government Reporting (SGR) Bureau within the SCO's Division of Accounting and Reporting (DAR) is tasked with responsibility for compiling and producing a CAFR using antiquated information technology systems, relying on agency-submitted financial information, and manually completing more than 950 individual tasks, with varying degrees of complexity. As noted by the CSA, staffing shortages and significant turnover contributed to many of the issues they identified. In addition, being denied additional resources and disparate classifications and compensation have added to the deficiencies.

- Over the past three years, the SGR has experienced serious staffing shortages, and had a vacancy rate of approximately 50 percent in November of 2013, just as the CAFR cycle was beginning. The high turnover rate primarily has been a result of prolonged and excessive overtime existing SGR staff have been required to work in order to produce the CAFR. The staffing shortage included managerial positions that had been vacant for about three years for want of qualified candidates, who bring appropriate knowledge and understanding of governmental accounting and reporting—qualifications which are critical to managing and producing the CAFR.
- The table below shows that in five of the last seven fiscal years, the SCO has been denied, through the budget process, the personnel resources needed to ensure that SGR is adequately and appropriately staffed.

FISCAL YEAR	POSITIONS REQUESTED	POSITIONS APPROVED
2008–09	2.0	2.0
2009–10	1.6	0
2010–11	5.0	0
2011–12	2.0	0
2012–13	–	–
2013–14	5.3	0
2014–15	5.3	0

In addition, in 2009, former Governor Schwarzenegger vetoed DOF-approved budget items and cut 10 percent of the SCO's budget just as the SCO was planning to add personnel more DAR resources.

After six years of being denied resources, the Controller was left with no choice but to utilize savings in other areas to hire additional staff. Since November of 2013, DAR has hired 12 staff and, out of necessity, temporarily redirected seven existing staff from other DAR programs and SCO Divisions to perform CAFR work. If these personnel changes had not been made, the CAFR would not have been completed

in April of 2014. Although most of the new staff possessed college degrees in accounting and otherwise met the State minimum qualifications for the classifications, many did not have the necessary experience in governmental accounting, implementing new accounting standards, and preparing the CAFR. Staff inexperience is clearly evident because of the 28 staff who worked to prepare the fiscal year 2012–13 CAFR, 18 (64 percent) had less than one year of CAFR preparation experience, and 20 (71 percent) had less than two years of experience.

- A classification and compensation study initiated by DAR and performed by independent consultants during 2011 and 2012 concluded that the classification and compensation structure within DAR was not competitive enough to effectively recruit and retain qualified staff, particularly in SGR. The study recommended that an-SCO-only classification with a higher salary range be established. The SCO approached the Department of Personnel Administration (now CalHR) to remedy this, but the proposal was denied because CalHR did not want to modify the classification structure. The table that follows illustrates this point for the Accounting Administrator I (Specialist) classification.

OTHER ENTITIES	COMPARABLE JOB CLASSIFICATION	MONTHLY SALARYMAX
State Controller's DAR	Accounting Administrator I, Specialist	\$5,874
State Dept. of Finance	Staff Finance Budget Analyst	\$6,433
Administrative Office of the Courts	Senior Accountant	6,883
Santa Clara County	Senior Accountant	7,686
Los Angeles County	Senior Accountant, A-C	7,366
Orange County	Senior Accountant/Auditor I	6,554
Sacramento County	Senior Accountant	6,431
San Diego County	Sr. Auditor & Controller Accountant	6,245
Contra Costa County	Accountant III	6,183
Riverside County	Senior Accountant	5,209
<b>MEAN</b>		<b>\$6,554</b>
<b>MEDIAN</b>		<b>\$6,433</b>

With regard to each of the deficiencies noted, the SCO worked with the CSA to immediately understand and correct the deficiency when it was brought to the SCO's attention. This allowed the CSA to render an unmodified opinion on the financial statements. In fact, most of these deficiencies were corrected by March 28, 2014, when the unaudited financial statements were issued. In response to each of the deficiencies noted:

### ***The Controller's Office Struggled to Effectively Implement New Standards***

#### ***150 Percent Increase in New GASBs Implemented in Fiscal Year 2012–13***

As noted in the following table, the number of GASBs implemented more than doubled in fiscal year 2012–13.

FISCAL YEAR				
2008–09	2009–10	2010–11	2011–12	2012–13
2	2	2	2	5

For fiscal year 2012–13, the SCO implemented five new accounting standards:

- GASB 60—Accounting for Service Concession Arrangements;
- GASB 61—The Financial Reporting Entity: Omnibus, an amendment of GASB Statements No. 14 and No. 34,
- GASB 62—Codification of Accounting and Financial Reporting Guidance Contained in Pre November 30, 1989 FASB and AICPA Pronouncements,
- GASB 63—Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position and
- GASB 65—Items Previously Reported as Assets and Liabilities.

### ***GASB 65 Early Implementation***

GASB 63 deals with financial reporting of deferred outflows and inflows of resources and their effects on net position, and goes hand-in-hand with GASB 65, which reclassifies certain items that were previously reported as assets and liabilities to deferred outflows and inflows of resources. The SCO chose early implementation of GASB 65 for the following reasons:

- Of the five new standards in fiscal year 2012–13, three standards, GASB 60, 63 and 65, required restatements of fund balances. Early implementation of GASB 65 allowed for more clear and consistent presentation of financial statements by showing the prior period adjustments in one year.
- The GFOA recommended, and the GASB encouraged early implementation of GASB 65 in conjunction with GASB 63.
- Industry audit and accounting professionals recommended concurrent implementation of GASB 63 and 65.

The SCO's process for implementing new accounting standards has been to work collaboratively with CSA by proposing our approach and methodology and requesting feedback and concurrence that our methodology and approach were appropriate and would provide accurate results to ensure successful implementation of the new standards.

### ***Golden State Tobacco Securitization Fund***

The CSA raised a number of issues regarding the implementation of GASB 65 and the Golden State Tobacco Securitization Fund (Tobacco Fund). These issues can be attributed to the incorrect sequencing of tasks in the CAFR plan, which caused the work to be performed out of order. As a result, a SCO policy analyst was analyzing the impact of GASB 65 transactions on the Tobacco Fund, at the same time an SCO accounting analyst was completing the actual CAFR tasks. Unfortunately, the SCO accounting analyst transmitted the CAFR tasks to the CSA for review prior to receiving guidance on the impact of GASB 65 on the Tobacco Fund, and the SCO was not able to correct the error prior to CSA auditing the tasks and finding the errors.

The SCO has already begun taking corrective action by hiring additional staff in the Policy unit and contracting with an external accounting firm with GASB expertise to provide more resources guidance, and training in the implementation of new accounting standards.

***The Controller's Office Made Material Errors When It Reversed Prior-Year Accruals***

The SCO acknowledges that the process for identifying and analyzing which entries need reversal could be improved. The errors regarding the Federal Trust Fund occurred because the desk procedures were not updated. By way of background, on average, 450 federal trust fund transactions must be keyed as part of the CAFR task. During the fiscal year 2011–12 CAFR cycle, the SCO developed the automatically generated Excel worksheet as a process improvement to reduce key data input of federal transactions and streamline the task. Additional procedures were written to explain how the Excel worksheet was to be used; however, due to high staff turnover, the existing desk procedures were not updated, which caused unintended downstream errors. Consequently, staff members working on this task for the FY 2012–13 CAFR used the Excel worksheet to bring in the federal transactions but failed to perform the required analysis to identify the entries requiring reversal.

The desk procedures for this task have been updated and we are beginning to train staff on the proper use of this Excel worksheet. In addition, the SCO now requires that any changes in tasks or procedures related to these matters are memorialized within 30 days of the change.

***The Controller's Office Improperly Prepared Numerous Current Year Adjusting Entries***

The SCO acknowledges that the process for preparing adjusting entries could be improved. However, it should be noted that posting several adjusting journal entries during the closing process is not uncommon in any entity, public or private. The observed increase in adjusting entries had several causes:

- Prior year changes or updates to desk procedures were not memorialized due to staff turnover. Consequently, the SCO made errors during the 2012–13 CAFR cycle that could have been avoided if the procedures had been properly updated.
- Misassignment of CAFR tasks resulted in multiple staff performing the same or related tasks, which in turn resulted in multiple attempts to correct the errors.
- Several agencies submitted poor quality and/or late reports of the financial data. For fiscal year 2012–13, at least 178 financial statements required revisions. In addition, 111 statements were submitted late. The inaccurate and late statements delayed the start of the CAFR tasks, and caused additional unanticipated work to be performed, thereby, reducing the amount of SCO staff time available to complete CAFR tasks.
- Financial statements are prepared on various accounting bases (cash, modified accrual and full accrual) depending on the type of fund that is being reported. The SCO receives various audit reports using the full accrual basis of accounting that must be analyzed and, by necessity, revised (requiring adjusting entries) to the modified accrual basis of accounting. In addition, there are various cash basis funds that require the SCO to revise and report on the modified accrual basis of accounting.

The SCO already has begun the process of ensuring that the desk procedures for all CAFR tasks have been updated, by requiring staff to review and update desk procedures by April 25, 2014, and will soon begin a quality assurance review of the desk procedures and provide training to all staff to ensure that these types of errors are reduced in the future. Also, the SCO will require that any changes in tasks or procedures are memorialized within 30 days of the change.

***The Controller's Office Lacked a Sufficient Review Process***

The SCO acknowledges that the review process needs to be strengthened. The worker's compensation error was corrected immediately once it was brought to the SCO's attention.

In late January of 2014, the SCO's management instituted an internal reviewer checklist to aid managers/supervisors with reviewing and approving work prior to its submission to the CSA. Following best practices, the SCO will adopt more stringent and robust analysis and review requirements by:

- Validating the mathematical accuracy of agency submitted numbers and reports;
- Comparing prior year balances to current year;
- Performing reasonable checks;
- Investigating abnormal balances;
- Using multiple levels of review and approval, and
- Performing quality assurance reviews to ensure that desk procedures are updated for changes to CAFR tasks.

As the SCO relies on agencies to provide valid, quality documents, it is reasonable to expect that agencies submit correct financial statements and reports. The SCO tracks financial statement revisions. Since the beginning of the decade, as displayed in the table below, there has been a marked increase (52 percent) in incorrect or inaccurate financial statements submitted to SCO.

FISCAL YEAR		
2010-11	2011-12	2012-13
117	182	178

Not included in above table are the many emails from state agencies requesting budgetary/legal and GAAP revisions to financial statements.

For example, the Department of Parks and Recreation used the incorrect revenue code to report \$2.1 million in revenue in its year-end financial reports. This caused the GAAP statements to be out of balance because the revenue code did not exist in the GAAP system. In another example, the Department of Health Care Services submitted year-end financial statements that were out of balance by \$806 million (assets did not equal liabilities).

Submission of inaccurate or incorrect statements delays the start of the CAFR tasks and causes additional work to be performed; thereby, reducing the amount of time available for SCO staff to complete and review CAFR tasks.

In addition to applying a more stringent and robust analysis and review process, SCO will work with State agencies and the DOE, as they are statutorily responsible for agency accounting policy, to address the rising number of errors in agency submitted financial reports and any training needed to reduce this trend.

### ***The Controller's Office Inaccurately Prepared Required Disclosures***

The SCO acknowledges that the process used to prepare the required disclosures should be strengthened. The SCO believes that the root cause of this problem is high staff turnover. As previously noted, 64 percent of staff assigned to work on the CAFR had less than one year of CAFR preparation experience. The three bullets below are examples of errors that can and will be corrected through training.

- The error described by the CSA in the Schedule of Revenue Bonds Outstanding in Note 16 was a transposition error that should have been identified during the review process.
- Incorrect financial information provided by two State agencies contributed to the error in the Schedule of Debt Service Requirements; however, this error also should have been identified during the review process.
- The omission of the Enhanced Tobacco Settlement Asset-Backed Bonds occurred due to staff turnover, as the SCO analyst performing the task was inexperienced, having less than one year of experience in performing CAFR tasks.

In addition to conducting enhanced training, the SCO already has initiated a more robust review process using an internal reviewer checklist that requires reported information to be compared with source documents and the GFOA disclosure checklist to help ensure that the required disclosures were included in the CAFR.

### ***Response to CSA Recommendations***

#### ***Recommendation:***

To effectively implement new standards, the Controller's Office should:

- Develop sound methodologies for implementing new accounting standards in the year prior to their effective date, whenever feasible. This is particularly important for complex standards like GASB 65.

#### ***SCO's Response***

The SCO has not always had the resources to work on the implementation one year prior to the effective date of the standard. In late April/early May 2014, the SCO hired additional staff in the Policy unit and contracted with an external accounting firm with GASB expertise to provide more resources and guidance in the implementation of new accounting standards.

- Provide specific implementation instructions to agencies and obtain any information including supporting documentation that the Controller needs to properly assess the impact of new standards on the CAFR.

#### ***SCO's Response***

The SCO has developed specific implementation instructions based on the accounting standards, and has provided the instructions to the CSA for review and input. However, agencies are not as cooperative as they should be in response to the SCO's implementation instructions. The SCO will follow up more thoroughly with agencies and ensure that they are aware that they are responsible for retaining documentation to support any responses and assertions they submit to the SCO. In addition, the SCO will require agency directors to certify, in writing, that their department evaluated the existence of transactions related to new standards such as GASB 60 and 65. However, the SCO is limited in its ability to collect this information as it is dependent on the expertise of staff within the agencies and their understanding of new GASB standards.

- Update its internal procedures to effectively address changes in accounting standards, as necessary.

#### ***SCO's Response***

The SCO already had begun the process of ensuring that the desk procedures for all CAFR tasks have been updated by requiring staff to review and update desk procedures by April 25, 2014, and will soon begin a quality assurance review of the desk procedures and training of staff to ensure that they understand the procedures to be followed. The SCO also will add a requirement that the Policy/Quality Assurance unit must update existing desk procedures for any new standards. Further, the SCO

will require that any changes in tasks or procedures be memorialized within 30 days of the change. During each staff exit interview, the SGR manager will confirm that any changes to procedures have been memorialized.

- Develop effective procedures that ensure that all material impacts on the CAFR are considered when implementing new accounting standards. This should include a methodology for identifying all accounts and types of transactions that could potentially be affected by a new standard and any agencies with material activity.

#### *SCO's Response*

In late April/early May 2014, the SCO hired additional staff in the Policy unit and contracted with an external accounting firm with GASB expertise to provide more resources and guidance in the implementation of new accounting standards.

To ensure that the CAFR is properly presented at fiscal year-end, the Controller should:

- Develop a more formal process for reviewing and approving entries before posting them into its GAAP accounting system.

#### *SCO's Response*

In late January of 2014, the SCO implemented a more formal process for reviewing and approving entries—all work was to be reviewed and signed off by management. SCO will provide more one-on-one staff and managerial training to ensure that the proposed entries are correct before posting.

- Develop a process to review financial statements after entries are posted to ensure the accuracy of account balances.

#### *SCO's Response*

The SCO has relied on a supervisory/managerial review to ensure that work is performed correctly. However, due to high staff turnover, the SCO will add an additional quality assurance review. The SCO began implementing its corrective action by hiring an additional manager in May of 2014. Among the manager's duties will be to develop and implement an additional quality assurance review process to ensure the accuracy of the financial statements. This new process will be layered on top of reviews already being performed.

- Develop a process to evaluate its desk procedures annually and update them as necessary.

#### *SCO's Response*

The SCO already had begun the process of ensuring that the desk procedures for all CAFR tasks have been updated by requiring staff to review and update desk procedures by April 25, 2014, and will soon begin a quality assurance review of the desk procedures and training of staff to ensure that they understand the procedures to be followed.

- Develop and implement proper controls to thoroughly evaluate the effectiveness of any newly developed procedures.

#### *SCO's Response*

As part of its corrective action plan, the SCO will develop a quality assurance review process whereby newly developed procedures will be reviewed and tested to ensure the procedures yield the appropriate results before being implemented. Staff will then be trained on how to apply the new procedures.

- Provide guidance and training to staff to ensure they understand key accounting concepts and the purpose of the tasks they perform.

#### *SCO's Response*

The SCO began implementing its corrective action by hiring a manager in May of 2014, to assess the skill level of staff and provide one-on-one training and core curriculum training to ensure that staff understand key accounting concepts and the purpose of tasks.

#### **Corrective Action Plan**

The SCO has identified the following additional issues and corrective actions it will pursue based on our internal review of the CAFR process and discussions with SGR staff.

#### *Issue—Internal and External Training*

Currently, colleges focus on mainly public accounting. Consequently, there is a lack of expertise and knowledge in the application of governmental accounting and reporting standards, which makes it difficult for staff to understand and implement accounting and reporting standards and produce a CAFR.

Action: DAR will create core courses that all SGR staff must attend. The courses will include, but not be limited to, working paper preparation, CAFR preparation, new accounting and reporting standards, using SCO's GAAP system, and implementing quality assurance reviews.

For agencies, DAR will:

- Continue the annual open house and expand the effort with a focus on those agencies that submit incorrect statements and reports;
- Develop a series of classes on the implementation of new accounting and reporting standards;
- Create a presentation for State departments so that they understand the importance of submitting correct financial statements as well as the significance and magnitude of the CAFR on the State's ability to conduct business; and
- Explore with the California Department of Finance the possibility of increasing the number and frequency of State fund accounting courses being offered to State agencies as there currently is a long waiting list for classes.

#### *Issue—Resources, including Classification and Compensation of Positions and Staff Retention*

SGR accounting analysts are not paid commensurate with their duties and responsibilities, or at the level of similar State or county entities. In addition, SGR staff work excessive and prolonged overtime during the CAFR cycle. Consequently, SGR traditionally has had problems in recruiting and retaining staff members who possess knowledge and expertise in governmental accounting and the preparation of the CAFR.

Action: The SCO will continue to pursue with CalHR an SCO-specific accounting classification with compensation commensurate with the work performed. The SCO will also explore the option of using recruitment and retention bonuses.

### *Issue—Incorrect and Inconsistent Agency Submitted Data*

As the SCO relies on agencies to provide valid, accurate documents and information, it is reasonable to expect that agencies submit correct financial statements and reports. The incorrect report submissions discussed above are not isolated incidents. The SCO tracks financial statement revisions and has determined that since the beginning of the decade, as displayed in the table below, there has been a marked increase (52 percent) in incorrect or inaccurate financial statements submitted to the SCO.

FISCAL YEAR		
2010-11	2011-12	2012-13
117	182	178

Not included in the tally in the table above were the numerous emails from State agencies requesting budgetary/legal and GAAP revisions to financial statements.

Submission of inaccurate or incorrect statements delays the start of the CAFR tasks and causes additional work to be performed; thereby, reducing the amount of time available for SCO staff to complete CAFR tasks.

Action: In addition to the above-mentioned training, DAR will follow up with the agencies that submit incorrect and inconsistent reports by performing site visits. Currently, Government Code Section 12461.2 allows the Controller to withhold the operating funds of an agency that submits late year-end financial reports. The SCO will explore the possibility of changing the Government Code to allow the Controller to withhold an agency or department director's salary until the financial statements are properly submitted.

### *Issue—Timing of Submission of Year-end Financial Reports*

Currently fiscal year-end reports are due July 31 for the General Fund, feeder funds and Special Fund for Economic Uncertainties; August 20 for special funds; and October 1 for independently audited financial statements and GAAP adjustments. Late financial statement submissions impact the start of the annual CAFR cycle and may cause duplicate work to be performed. For fiscal year 2012–13, there were 111 financial statements submitted late, which impacted the start of the CAFR tasks.

Action: The SCO will contact the California Department of Finance to explore the possibility of changing the required due dates for the year-end reports. Beginning with the fiscal year 2013–14 report submissions, the SCO will post on the SCO website a list of the agencies that submit late reports.

### *Issue—Changing Bases of Accounting for Funds*

For budgetary purposes, the State of California is moving further and further away from GAAP standards. Use of other than GAAP requires additional adjustments to the financial statements and creates the potential for misstatements.

Action: The SCO will explore the possibility of introducing new, or changing existing legislation, to adhere more closely to a GAAP-based standard.