



State of California

Internal Control and Compliance Audit Report
for the Fiscal Year Ended June 30, 2015

Report 2015-001.1

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March 18, 2016

2015-001.1

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 State Auditor's Office presents its audit report concerning our review of the State of California's internal controls and compliance with state regulations for the year ended June 30, 2015.

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. We identified one deficiency in internal control over financial reporting that we consider to be a material weakness. 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**

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

Independent Auditor's Report

The Governor and the Legislature of the State of California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated March 11, 2016. 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 78 percent of the assets and deferred outflows and 36 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 94 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- The Safe Drinking Water State Revolving fund, that represents 16 percent of the assets and deferred outflows, and 5 percent of the additions, revenues, and other financing sources of the Environmental and Natural Resources fund, a major governmental fund.
- The following major enterprise funds: Electric Power fund, Water Resources fund, State Lottery fund, and California State University fund.
- The Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control, and the 1943 Veterans Farm and Home Building funds, that represent 86 percent of the assets and deferred outflows, and 33 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, 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.

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, we identified a deficiency in internal control that we consider to be a material weakness as described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements.

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. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Entity's Responses to Findings

The State of California's response to the finding identified in our audit is described in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. The State's response was not subjected to the auditing procedures applied in the audit and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the 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

March 11, 2016

Schedule of Findings

**STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2015**

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?	No
Noncompliance material to financial statements noted?	No

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

DEPARTMENT OF HEALTH CARE SERVICES

Reference Number: 2015-001

Condition:

The Department of Health Care Services (DHCS) overstated Medi-Cal expenditures for fiscal year 2014–15 in the General Fund by \$1.149 billion. Additionally, DHCS overstated Medi-Cal expenditures and revenues for fiscal year 2014–15 in the Federal Trust Fund by \$1.023 billion. Lastly, in various funds within the Non Major Governmental Funds, DHCS understated expenditures and revenues by \$237 million and \$16 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 must be recognized in the accounting period in which they are incurred. Additionally, the related federal funding should be recognized when all applicable eligibility requirements, including time requirements, are met. 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' misstatements by program.

Overstated Accruals for Managed Care and Other Shared Programs

DHCS overstated expenditures and related revenues by \$602.3 million in the Federal Trust Fund, and overstated expenditures by \$325.7 million in the General Fund, for the Medi-Cal Managed Care (Managed Care) Program. Managed Care health plan providers help Medi-Cal beneficiaries find doctors, pharmacies and health education programs. These providers are paid a monthly rate for each individual enrolled with them. DHCS validates provider information and generates invoices for payment to Managed Care Plans. DHCS uses its Capitation Management (CAPMAN) system to generate the validated invoices. To prepare its accrual, DHCS must identify any unpaid invoices for services provided by June 30, 2015. DHCS relied upon a query of the CAPMAN data to obtain this information. However, the CAPMAN data included paid invoices and these invoices were erroneously accrued. DHCS indicated this error occurred because the staff preparing the accrual were unfamiliar with the data.

Additionally, DHCS overstated expenditures and revenues in the Federal Trust Fund by \$480.6 million and overstated expenditures in the General Fund by \$432.4 million when preparing accruals for all the program services it coordinates with the Department of Social Services (DSS), including a new Managed Care program. Beginning in April 2014, DHCS began transitioning care for certain recipients of the In Home Supportive Services (IHSS) program from Fee-for-Service to Managed Care. The IHSS program provides an in home alternative to other traditional out-of-home settings such as nursing homes. Because DSS is involved in the administration of this and other programs it is important for DHCS to effectively coordinate with DSS when preparing the necessary accruals. However, we found there was an ineffective reliance on email communication and little formal guidance available for staff to use when preparing the GAAP accruals.

Overstated DHCS Medi-Cal Expenditure and Revenue Accruals

DHCS overstated expenditures and revenues by \$409 million in both the Low Income Health Program Fund within the Non Major Governmental Funds and the Federal Trust Fund. The Low Income Health Program Fund finances the cost of providing certain health care services to a defined population of uninsured adults who are not otherwise eligible for Medicare or Medi-Cal. DHCS prepared accruals related to its request for additional federal funding from the Centers for Medicare and Medicaid Services (CMS). Staff at DHCS prepared this accrual based on the inclusion of the anticipated funding in certain budget documents. However, CMS denied the request for additional funding and so the accruals for both the Low Income Health Program Fund and the Federal Trust Fund are not valid. DHCS failed to provide sufficient guidance to those staff preparing this

GAAP accrual. Insufficient guidance also contributed to two additional overstatements. Specifically, DHCS overstated expenditures and related revenues by \$135.9 million in the Federal Trust Fund and overstated expenditures by \$137.8 million in the General Fund for the Fee-For-Service Health Care Delivery System. It also overstated expenditures and related revenues by \$171 million in the Federal Trust Fund for the Health Care Support program.

Understated DHCS Medi-cal Expenditure and Revenue Accruals

DHCS understated expenditures and related revenues by \$393 million in the Federal Trust Fund and the Public Hospital Investment, Improvement, and Incentive Fund within the Non Major Governmental Funds for the Delivery System Reform Incentive Pool (DSRIP) program. DSRIP provides funding to create financial incentives for certain Designated Public Hospitals' to pursue delivery-system reforms. Those reforms involve infrastructure development, system redesign, and clinical-outcome and population-focused improvements. DHCS failed to accrue expenditures for services provided by June 30, 2015 that were scheduled for payment in the following fiscal year. This understatement occurred because DHCS relied heavily on email communication between accounting and program staff preparing the accrual, and as a result, there was a miscommunication regarding the level of unpaid services.

DHCS also understated expenditures and related revenues by \$383.1 million in the Federal Trust Fund for the Specialty Mental Health Consolidation program, which provides specialty mental health services to qualifying Medi-Cal recipients. This error occurred primarily because DHCS failed to update its accrual methodology to include the additional federal funding available through the Affordable Care Act. DHCS indicated this oversight was the result of a recent change in how it accounts for the Affordable Care Act in certain budget documents and staff did not carry forward this change into the accrual methodology for the Specialty Mental Health Consolidation program.

Misstated Reimbursement Accruals

DHCS understated expenditures by \$253.3 million in the Children's Health and Human Services Fund (Children's Health Fund) within the Non Major Governmental Funds and overstated expenditures by \$253.3 million in the General Fund. The Children's Health Fund receives a tax imposed on the sellers of Medi-Cal Managed Care plans. A portion of this tax reimburses the General Fund for certain Medi-Cal related costs. DHCS' accrual methodology directs staff to accrue this reimbursement; however, staff failed to do so for a portion of tax revenues received prior to June 30, 2015. In this instance, staff preparing the accrual did not have a sufficient understanding of the underlying flow of program funding to prepare an accurate accrual.

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. 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). To prepare its financial report, the Controller's Office annually requests that departments submit GAAP-related adjustments 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 expenditures to be reported when the related liability has been incurred except in certain limited circumstances.

Codification of Governmental Accounting and Financial Reporting Standards Section N50 states that for government-mandated non-exchange transactions recipients should recognize revenues when all applicable eligibility requirements, including time requirements, are met. When the modified accrual basis of accounting is used, revenues resulting from non-exchange transactions should also be available.

Codification of Governmental Accounting and Financial Reporting Standards Section 1800 defines reimbursements as repayments from the fund responsible for a particular expenditure to the fund that initially paid for them. Reimbursements should not be displayed in the financial statements. The GAAP manual instructs agencies to record a reduction in expenditures for the reimbursed fund and to record an increase in expenditures for the reimbursing fund.

Recommendation:

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

- Improve internal communications among program and accounting staff who prepare the GAAP accruals.
- Update existing accrual methodologies as needed and create new methodologies for those programs for which none exist.
- Provide additional guidance and training to program and accounting staff on the requirements of GAAP.

Department's View and Corrective Action:

DHCS agrees with the recommendations. DHCS has already begun efforts to address the issues described within this report for the fiscal year 2015–16 GAAP accruals. Specifically, the DHCS Accounting Section has prepared a GAAP Accrual Enhancement Plan (plan) to improve the GAAP accrual process. The plan calls for existing Accounting Section staff to be reassigned from other duties for a period of six to eight weeks to a temporary GAAP accrual focus team. These individuals will be selected based on their experience in working with more complex accounting tasks to work collaboratively with other existing staff in developing written GAAP accrual guidelines, methodologies, and training materials. The plan calls for the selection of the team members by March 2016 and the outlined accrual methodologies completed by June 2016 with the updated finalized methodologies to be in place by August 2016. Training for program level staff who participates in the GAAP accrual process is planned for June 2016. The DHCS Accounting Section plans to improve its communication among all staff by developing these standard written procedures and by providing each program division with a single point of contact within the Accounting Section.

March 2016

Date: March 18, 2016

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