REPORT BY THE AUDITOR GENERAL OF CALIFORNIA

A REVIEW OF THE STATE'S CONTROLS OVER ITS FINANCIAL OPERATIONS

F-005

MARCH 1991

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Honorable Robert J. Campbell, Chairman
Members, Joint Legislative Audit Committee
State Capitol, Room 2163
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the results of our review of the State's control of its financial activities and its compliance with federal grant requirements and state regulations. This review was made as part of our examination of the State's general purpose financial statements. This report fully meets the requirements of the 1984 Single Audit Act set forth by the United States Government as a condition of receiving over $13 billion in federal funds annually.

The State continues to lose millions of dollars each year because agencies do not promptly identify and collect amounts owed to the State, do not effectively control expenditures, and do not manage cash to maximize benefits to the State. In addition, the State continues to have numerous shortcomings in its financial reporting system that need to be resolved by the State's financial leadership. For example, the State does not prepare its budget based on generally accepted accounting principles (GAAP) and does not have an accounting system that presents the financial condition of the State based on GAAP when reporting on the past execution of its budget. Instead, the state fiscal control departments report the financial condition of the State by using different accounting practices. This use of different accounting practices can cause the State's financial decision makers to be uncertain about the State's true financial condition.

Respectfully submitted,

Kurt R Sjoberg

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Auditor General (acting)

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F-005, March 1991

Office of the Auditor General
California

Summary

Status of Internal Controls

Although the State of California has corrected some of the weaknesses in its internal controls that we have reported in recent years, it has many more weaknesses to correct. The State has weaknesses in its accounting and administrative control structure that result in inaccurate financial statements, noncompliance with state and federal regulations, and the waste, loss, and misuse of state resources. For fiscal year 1989-90, 20 of the 24 agencies at which we reviewed the internal control structure had weaknesses in the controls over its financial activities.

To obtain satisfactory audit coverage, we selected agencies that we determined to be the most material in relation to the major segments of the various funds in the general purpose financial statements. As a result, we audited 24 agencies, which represented approximately 61 percent of the State's revenues and approximately 60 percent of the State's spending. Other independent auditors audited an additional approximately 33 percent of the State's revenues and an additional approximately 22 percent of the State's spending. We also reviewed selected internal control procedures at 3 agencies for fiscal years 1988-89 and 1989-90, and we audited the financial operations of 3 other agencies for fiscal year 1988-89.

Actual and Potential Losses

The State may have lost approximately $2.8 million in foregone interest and discounts because the State did not promptly collect moneys owed to it or did not promptly pay invoices. Because the State does not always follow established collection procedures, it may also have difficulty collecting some of the approximately $21.8 million owed to it. Further, the State may have lost approximately $215,600 in revenues and may have incurred unnecessary expenditures of approximately $1.8 million. These amounts do not represent all the potential or actual losses the State may have incurred because these estimates were identified by reviewing a sample of transactions. Appendix A presents a schedule, by state agency, of actual and potential losses identified by our testing.

Many of the weaknesses in internal controls that we observed did not result in losses. However, if state agencies do not correct the weaknesses and provide proper controls over their operations, the opportunity exists for the State to suffer more serious losses in the future.

Statewide Concerns

The State continues to have numerous shortcomings in its financial reporting system that need to be resolved by its financial leadership. The State does not prepare its budget based on generally accepted accounting principles (GAAP) and does not have an accounting system that presents the financial condition of the State based on GAAP when reporting on the past execution of its budget. In addition, the State Controller's Office and the Department of Finance use different accounting practices. This use of different accounting practices can cause the State's financial decision makers to be uncertain about the State's true financial condition. Further, the State must make numerous adjustments to its financial statements to prepare them in accordance with GAAP so that they may be comparable to the financial statements of other states and acceptable to the investment community and the federal government. GAAP is the preferred method of accounting because it is a nationally recognized set of accounting principles that improves accountability, since under GAAP costs are recognized when they occur, not when they are paid for.

Furthermore, the State currently does not recognize some expenses when reporting on the past execution of the State's budget. These expenses include the cost of Medi-Cal services provided but not yet paid for and the cost of earned vacation for certain state faculty. Moreover, the State recognizes as revenues, tax overpayments that will have to be refunded or applied to future years. Beginning in fiscal year 1991-92, the State plans to change its accounting for Medi-Cal expenditures and uncollected taxes to methods that are in accordance with GAAP.

In addition, the State does not preclude state agencies from contracting with fiscal agents to pay invoices with state funds deposited in the bank accounts of these fiscal agents at the direction of the state agencies. Further, the State does not have adequate control over contracts for grants to local governments.

During fiscal year 1989-90, we became aware of two additional statewide concerns. Specifically, the State's revenue collection agencies cannot make refunds and distributions of revenue when the State has no budget. As a result, the State incurs additional interest and personnel costs. In addition, state agencies are not always depositing their federal receipts in the Federal Trust Fund.

We noted other weaknesses. For example, the State does not produce audited financial statements within six months of the end of the fiscal year, it does not include in its audited financial statements the combining statements that provide the financial statements of each of the funds within the fund types, and it does not properly account for billions of dollars of fixed assets. As a result of these three weaknesses, as we have reported for the last four years, the State does not qualify for the Certificate of Achievement for Excellence in Financial Reporting. The State also continues to spend unnecessary additional time and effort in preparing the financial statement disclosures required by GAAP for the State's lease commitments because the State does not have a central record of lease commitments that contains all the necessary information. Further, the State's method of accounting for federal assistance does not yet provide sufficient information on expenditures of federal moneys for each federal program.

Weaknesses at State Agencies

Many of the agencies we audited had weaknesses in internal controls over financial reporting, revenue, and expenditure activities. We also noted immaterial instances of noncompliance with state and federal regulations at several agencies. Some deficiencies in internal controls were common throughout the State.

Weak Controls Over Financial Activities

Eleven of the agencies we audited had weaknesses in their internal controls over financial reporting. Problems we found included incorrect or nonexistent reconciliations, inappropriate accounting practices, and inadequate accounting of property and inventory. These problems resulted in inaccurate financial statements. For example, the Stephen P. Teale Data Center (data center) overstated its equipment balance at June 30, 1990, by $1.4 million. This overstatement occurred because the data center did not have sufficient accounting controls in place to ensure that items sold or removed from service before the end of the fiscal year were removed from the equipment balance.

Sixteen of the agencies we audited had weaknesses in internal controls over revenue activities. Problems we found included failure to bill for and collect receivables, failure to follow proper procedures for recognizing revenue earned, and failure to deposit receipts promptly. These problems resulted in receivables that may be difficult to collect, in inaccurate financial statements, and in the loss of interest revenue. For example, because the Department of Social Services did not always properly control its cash management system for the federal government's share of the department's local assistance expenditures, it lost approximately $1.2 million in potential interest income.

Problems involving expenditure activities existed at 19 of the agencies we audited. The problems we found included insufficient control over payroll, insufficient monitoring and control over revolving fund activities, improper separation of duties, and other weaknesses in control over disbursements. Weaknesses in controls over expenditures can result in the loss of state funds.

Lack of Compliance With State Regulations

The State complied in all material respects with all state regulations that could materially affect the State's financial statements. However, at a few agencies we found that certain immaterial instances of noncompliance existed in apportioning moneys to schools and in purchasing materials, equipment, and services through contracts. Although these weaknesses did not have a material effect on the financial statements, the weaknesses could result in improper amounts being paid to schools and in the State's interests being put at risk because of improper contracting.

Lack of Compliance With Federal Regulations

In fiscal year 1989-90, the State received approximately $13.7 billion in federal grants. At many state agencies, we noted immaterial instances of noncompliance with the federal regulations for administering these federal grants. Adherence to these regulations is a condition of continued federal funding. The State did not fully comply with all federal regulations in 37 of the 42 grants we reviewed.

These 42 grants represent approximately 96 percent of all federal moneys the State received for fiscal year 1989-90, excluding those received by the University of California. Our review showed that agencies failed to adhere to requirements for reporting, for cash management, and for program monitoring and auditing. The federal government could penalize the State because of its failure to comply with federal regulations.

Introduction

As part of our examination of the general purpose financial statements of the State of California for the fiscal year ended June 30, 1990, we studied and evaluated the State's internal control structure. The purpose of our study of this structure was to determine the audit procedures and the extent of testing necessary for (1) expressing an opinion on the State's general purpose financial statements, (2) determining compliance with federal grant requirements, laws, and regulations, and (3) determining compliance with state laws and regulations that could materially affect the general purpose financial statements. In conducting our audit, we reviewed and evaluated fiscal controls at 24 of the 313 state agencies included in the general purpose financial statements.

Amounts that we audited at these agencies represented approximately 61 percent of the State's revenues and approximately 60 percent of the State's spending. Further, other independent auditors audited an additional approximately 33 percent of the State's revenues and an additional approximately 22 percent of the State's spending. In addition to this audit coverage of the State's revenues and spending, we increased our coverage with centralized testing, which we performed by selecting for review a cross section of items from the State as a whole. For example, we selected a sample of payroll warrants the State processed through its payroll system, and we selected a sample of warrants other than payroll warrants that the State processed through its claims payments system. We also reviewed electronic data processing activities at selected state agencies that have significant data processing operations.

We reviewed selected internal control procedures at three agencies for fiscal years 1988-89 and 1989-90, and we audited the financial operations of three operating departments for fiscal year 1988-89. We issued the audit results of these six operating departments after we issued the State of California Comprehensive Financial and Compliance Audit Report for the Year Ended June 30, 1989. We include the results of these audits in this report.

We reviewed 24 agencies' compliance with state laws and regulations that materially affect the State's financial statements. Compliance with these laws and regulations helps to ensure that the State maintains sufficient control over the budgeting, investing, collecting, and disbursing of state moneys and that it maintains sufficient control over reporting the results of state financial activities.

Finally, except for the Pell Grant Program, which is reviewed by other independent auditors, we reviewed the State's compliance with federal regulations for all federal grants over $20 million. In all, we reviewed 42 of the 275 federal grants the State administers. These 42 grants represent approximately 96 percent of the federal funds the State received in fiscal year 1989-90, excluding those funds the University of California received. In addition, as part of our examination of the State's financial statements, we selected transactions related to other federal programs and reviewed these transactions for compliance with applicable federal regulations.

The specific scope of our audit is stated in the following reports that the federal Office of Management and Budget, Circular A-128, requires the State to issue each year:

- The report on the internal control structure used in preparing the general purpose financial statements and in administering federal assistance programs (begins on page 35);

- The report on weaknesses and instances of noncompliance at state agencies (begins on page 41):

- The report on federal assistance programs, including required reports on (1) compliance with laws and regulations related to major and nonmajor federal programs, (2) the accuracy of the supplementary schedule of federal assistance, and (3) the resolution of prior year findings related to federal programs (begins on page 329); and

- The report on compliance with state laws and regulations (begins on page 381).

Between July 1, 1989, and December 31, 1990, the Office of the Auditor General issued 55 audit reports, many of which discussed improvements needed in the State's operations. These reports, listed in Appendix B, are available to the public.

Statewide Concerns

Summary

The State of California continues to have numerous shortcomings in its financial reporting system that need to be resolved by the State's financial leadership. Partly because it does not use nationally recognized accounting principles to determine the State's budget and to report on the past execution of the State's budget, the State has inconsistently reported its financial condition. The State also does not provide sufficient instructions to make an efficient and reliable conversion of the financial reports from their presentation in accordance with the State's statutory and regulatory requirements (budgetary basis) to a presentation in accordance with generally accepted accounting principles (GAAP). Moreover, the State does not ensure that the charges of internal service funds to federal programs are in compliance with federal regulations. Also, revenue collection agencies are unable to make refunds or revenue distributions when the State has no budget. In addition, the State does not maintain adequate control over payments of invoices with state funds deposited in the bank accounts of fiscal agents. Furthermore, the State does not yet qualify for the Certificate of Achievement for Excellence in Financial Reporting because it does not produce audited financial statements within six months of the end of the fiscal year, it does not include the combining statements that provide the financial statements of each fund within the fund types, and it does not account for its fixed assets properly. In addition, the State does not deposit all of its federal receipts into the Federal Trust Fund, it does not have a central record of state leases that contains all the information required by GAAP, and it does not have sufficient control over contracts that are not subject to approval by the

Department of General Services. Further, the State's method of accounting for federal assistance does not provide sufficient information on expenditures of federal moneys for each federal program. Finally, the State does not require the District Agricultural Associations to submit financial reports to be included in the State's financial statements and does not require other agencies to submit certain reconciliations and reports.

Inconsistent Financial Reporting

As we reported last year, the State does not prepare its budget based on GAAP and does not have an accounting system that presents the financial condition of the State based on GAAP when reporting on the past execution of its budget. In addition, the State Controller's Office and the Department of Finance each report on the financial condition of the State using different accounting practices. This use of different accounting practices can cause the State's financial decision makers to be uncertain about the State's true financial condition. Further, the State must make numerous adjustments to its financial statements to prepare them in accordance with GAAP so that they may be comparable to the financial statements of other states and acceptable to the investment community and the federal government. GAAP is the preferred method of accounting because it is a nationally recognized set of accounting principles that improves accountability, since under GAAP costs are recognized when they occur not when they are paid.

Further, although the State began accounting for General Fund encumbrances in accordance with GAAP, it still does not account for other expenses and revenues in accordance with GAAP when reporting on the past execution of its budget. The State does not recognize some expenses, including the cost of Medi-Cal services provided but not yet paid for and the cost of earned vacation for certain state faculty. Also, the State has historically recognized some events as expenses even though no cost has been incurred. For example, the State reports loans from the State's General Fund to other funds as expenses rather than recognizing that money was lent to another fund and will be returned to the General Fund. Additionally, the State recognizes as revenue, tax overpayments that will have to be refunded or applied to future years. Beginning in fiscal year 1991-92, the State plans to change its accounting for Medi-Cal expenditures and uncollected taxes to methods that are in accordance with GAAP.

The following schedule displays the adjustments that were needed to present the fund balance of the State's General Fund (as reported by the State Controller's Office) in accordance with GAAP.

	Amount (in thousands)
Total Fund Equity per the State Controller's Office	$493,824
Medi-Cal Services Provided but Not Paid for	(798,599)
Earned Vacation Leave Not Paid for	(91,430)
Loans That Will Be Repaid	89,369
Tax Overpayments	(556,666)
Other Adjustments	(2,552)
Total Fund Equity per Audited GAAP Report	($866,054)

Adjustments were also necessary to present the fund balances of the State's other fund types (as reported by the State Controller's Office) in accordance with GAAP. For example, the State recognizes as revenue its authorized but unissued bonds. Under GAAP, the proceeds from bonds should not be recognized until the sale occurs. In addition, the State reports as expenses certain orders to acquire goods and services even though the State could still cancel the order after June 30 and even though the goods or services would not benefit the State during the current fiscal year because they would not arrive until the next fiscal year.

Problems With the State's Conversion to GAAP

The California Government Code, Section 12460, requires the State Controller's Office to prepare an annual report containing a statement of the funds of the State, its revenues, and the public expenditures of the preceding fiscal year on the same basis as that of the governor's budget and the budget act (budgetary basis). This section also requires that the format of the budgetary report be prepared as closely as possible in accordance with GAAP. The State Controller's Office currently issues the Annual Report of the State of California in conformance with the State's budgetary basis of accounting, which is not in accordance with GAAP. The State Controller's Office must then convert the State's financial statements to GAAP to prepare the State's general purpose financial statements. The Department of Finance has not provided sufficient instructions to the agencies in the State Administrative Manual to make this conversion from the budgetary basis to GAAP efficient and reliable. As a result, the financial information that agencies provide to the State Controller's Office is frequently insufficient for the State Controller's Office to prepare the State's general purpose financial statements in accordance with GAAP. For example, the Franchise Tax Board and the Board of Equalization do not provide information to the State Controller's Office on tax overpayments that are required to be recognized as liabilities in accordance with GAAP.

In addition, some of the financial information required under GAAP is more extensive than the information provided by the budgetary basis of accounting. As a result, the State must develop additional information for proprietary funds, lease commitments, and the market value of the State's investments in securities to create its general purpose financial statements.

The State is in the process of converting from the budgetary basis to GAAP in certain areas. The Department of Finance has rewritten some sections of the State Administrative Manual covering proprietary funds to bring them into conformance with GAAP. In addition, in the last three governor's budgets, the Department of Finance treated the State's General Fund encumbrances as a reservation of fund balance rather than as expenditures and has extended this treatment to the year-end financial statements. This treatment is consistent with GAAP in that encumbrances are obligations for which goods and services have not been received and should not be shown as expenditures. Further, the State's Fund Manual has been rewritten to bring it into conformance with GAAP. Until the State incorporates all of the necessary generally accepted accounting principles into state law, the State must continue to spend time and money to convert its financial records from the budgetary basis to GAAP so that they are comparable with those of other governmental entities and, therefore, acceptable to the investment community and the federal government under the single audit act.

Some Internal Service Funds Do Not Always Comply With Federal Regulations

The State has a possible liability to the federal government estimated to be as much as $24.6 million for profits it has accumulated in its internal service funds between July 1, 1984, and June 30, 1990. This condition exists because the Department of Finance has not ensured that charges to federal programs are in compliance with federal regulations. The State's internal service funds provide goods and services to state agencies and charge them for these goods and services. In turn, the state agencies have passed these charges on to federal programs that the State administers. When the charges of internal service funds exceed the costs for providing services, the State accumulates profits in its internal service funds.

In 1984, the federal Department of Health and Human Services (DHHS) audited the State's rate-setting methods for internal service funds. As a result, the State was required to refund to the federal government approximately $14.9 million of the profits accumulated in its internal service funds. This amount represented the federal share of profits accumulated by five of the State's internal service funds from July 1, 1969, to June 30, 1984. Because the State's internal service funds continue to accumulate profits, the State may be liable to the federal government for the portion of the additional surplus accumulated between July 1, 1984, and June 30, 1990, that represents charges to federal programs.

Using procedures similar to those of the Department of Finance and using the same percentages that were used to determine the federal share of the State's profit in the 1984 audit, we estimate that, under current federal regulations, the State may owe the federal government as much as $24.6 million. This amount is the federal share of profits accumulated by three of the five internal service funds mentioned above from July 1, 1984, to June 30, 1990, less audit adjustments and undercharges to federal programs of approximately $450,000 for the other two funds. Since the federal government and the State's executive branch are ultimately responsible for negotiating any final settlement, we did not attempt to determine whether the percentage that the federal government accepted to determine the federal share of the State's accumulated profits in the 1984 audit is still acceptable for the period from July 1, 1984, to June 30, 1990. In addition, an October 1988 amendment to the federal Office of Management and Budget (OMB), Circular A-87, Cost Principles for State and Local Governments, that has been proposed but not yet approved would allow state agencies a reasonable working capital reserve of 60 days cash expenditures. If approved, this amendment may reduce the liability for three of the funds to approximately $12.3 million.

While the State's internal service funds may be in compliance with state laws that allow them to accumulate surpluses up to certain limits, they may also be in noncompliance with the current provisions of OMB, Circular A-87. OMB, Circular A-87, does not allow the State to charge federal programs for amounts that exceed costs. The California Government Code, Section 13070, provides the Department of Finance with general powers of supervision over all matters concerning the financial and business policies of the State. Therefore, it is the responsibility of the Department of Finance to provide adequate guidelines to the agencies that administer internal service funds to ensure that charges to federal programs are in compliance with federal regulations.

The State Cannot Make Refunds and Distributions When It Has No Budget

The State's revenue collection agencies are unable to make refunds of tax overpayments or to distribute tax revenue to local governments when the State has no budget because the State Controller's Office will not process the refunds or the revenue distributions during these periods. The California Government Code, Section 13340, requires that, as of July 1 in a given fiscal year, no money in any fund that is continuously appropriated by any statute other than the budget act may be encumbered unless the Legislature specifies by statute that the money in the fund is appropriated for encumbrance.

During the 31 days in July 1990, when the State had no budget, the Board of Equalization, the Employment Development Department, and the Franchise Tax Board were prevented from paying tax refunds. This occurred even though the agencies had determined that the money did not appropriately belong to the State and was available in the accounts that had been specifically set aside for making refunds. According to a Franchise Tax Board official, the Franchise Tax Board incurred additional costs, including supplemental interest owed to taxpayers for delayed refunds and extra personnel costs for processing shutdowns and special manual procedures. We estimate that the Franchise Tax Board incurred more than $414,000 of additional interest and personnel costs.

Also during July 1990, the Board of Equalization was unable to make refunds and distribute approximately $338 million in sales tax revenues it had collected on behalf of local governments.

Inadequate Accountability Over Payments of State Funds By Fiscal Agents

The State Administrative Manual, Sections 19462 and 19463, requires departments to obtain approval from the Department of Finance to deposit moneys not under the control of the State Treasurer's Office in banks or savings and loan associations outside the centralized state treasury system unless the departments have statutory authority for such accounts. These sections also require departments to submit a report to the State Controller's Office and the State Treasurer's Office stating the balance in each of these types of accounts as of June 30 each year. Guaranty deposits, private trusts, and special purpose trusts are examples of accounts outside the centralized state treasury system. The requirements for approval and reporting exist to limit the State's risk related to transactions that are not subject to review by the various state control agencies.

However, the State Administrative Manual is silent regarding state departments that contract with fiscal agents whose sole responsibility is to pay invoices with state funds deposited in the bank accounts of these fiscal agents at the direction of the state departments. Payments by these fiscal agents are not subject to review by the various state control agencies even though state departments direct the payments to vendors. Last year, we reported that one department used fiscal agents to circumvent state civil service hiring rules, state procurement rules, and state contracting rules. Without regulations to control the use of fiscal agents, similar abuses could occur in the future. We recommend that the Department of Finance revise the State Administrative Manual to specifically preclude state departments from contracting with fiscal agents whose sole responsibility is to pay vendor invoices at the direction of state departments.

Delays in Producing Audited Financial Statements

The State has been unable to produce the necessary financial reports in time to issue audited financial statements within six months of the end of the fiscal year, a time requirement established in 1980 by the Government Finance Officers Association. While major corporations such as IBM, General Motors, and Pacific Gas and Electric are required to issue their audited annual financial reports within 90 days after the close of the fiscal year, the State has 180 days. However, the State has repeatedly taken over 200 days to issue its audited financial report. The financial statements for fiscal year 1989-90 were issued on January 30, 1991.

To address this concern, the Office of the Auditor General contracted with Price Waterhouse to evaluate the State's financial reporting system. Price Waterhouse identified shortcomings throughout the State's financial reporting system and made recommendations for correcting them. In response to Price Waterhouse's recommendations, a committee consisting of representatives from various state control agencies has been formed to improve the State's reporting system. The committee has initiated a pilot project to make financial reporting more accurate and prompt. The project involves the development of automated reconciliations of agency records with records of the State Controller's Office, a proposed reduction in the number of reports required from agencies, and a preliminary plan for electronic reporting of year-end financial data to the State Controller's Office.

Lack of Combining Statements by Fund Type

The State has not included combining statements by fund type in its audited financial statements. These combining statements provide financial statements of each of the individual funds within the fund types shown in the general purpose financial statements. Section 2200.101 of the Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, states that every governmental unit should prepare a Comprehensive Annual Financial Report, which includes general purpose financial statements by fund type and account group as well as the combining statements by fund type and individual fund statements.

The State has not prepared combining statements by fund type in accordance with these guidelines issued by the Governmental Accounting Standards Board. The State's system accounts for its funds in a manner that, in some cases, is not in full agreement with GAAP. For example, the State accounts for some of its funds as Trust and Agency and Capital Project Fund Types on the budgetary basis, but reports the same funds in the Special Revenue Fund Type in the general purpose financial statements.

Insufficient Accountability For Fixed Assets

State agencies do not maintain sufficient records either to determine or to estimate the original cost of acquiring general fixed assets, nor does the State maintain a complete listing of its fixed assets. This lack of records makes it impossible for the State Controller's Office to present the general fixed assets account group in the State's general purpose financial statements. Moreover, without these records, the State is unable to maintain sufficient control over fixed assets, exposing itself to an increased risk of the loss of these assets. Section 1400.110 of the Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, requires that fixed assets be accounted for at cost or, if the cost cannot be easily determined, at estimated cost.

To resolve this ongoing problem, the State created a Fixed Asset Task Force, which includes representatives from various state agencies. The objective of the task force is to provide recommendations that will allow the State, with minimal cost, to report general fixed assets in accordance with the law and GAAP.

Further, legislation enacted in 1986 created Section 11011.15 of the California Government Code, which requires the Department of General Services to develop a complete and accurate statewide inventory of real property held by the State by January 1, 1989. Section 11011.15 also requires the Department of General Services to include the cost of the property if it is available and a description of each major structure on the property in the statewide inventory. Thus, the State would have a central listing of land and buildings that could be reconciled with state agency records and used as a source of information for the State's general purpose financial statements. As land and buildings constitute a major portion of the State's general fixed assets, this statewide inventory should contribute significantly to resolving the State's problems in reporting general fixed assets. The budget acts for fiscal years 1988-89 and 1989-90 included funding to develop and maintain the statewide inventory of real property. The Department of General Services has not yet completed the inventory but estimates that it will have the completed inventory for June 1991 by October 1991.

Not All Federal Receipts Are Deposited Into the Federal Trust Fund

The State may be misstating its Schedule of Federal Assistance and may not be identifying all federal funds subject to audit under the Single Audit Act of 1984. This situation exists because state agencies delay depositing their federal receipts to the State's Federal Trust Fund or do not use the Federal Trust Fund at all.

The California Government Code, Section 16360, requires that all money received by the State from the United States shall be deposited in the State's Federal Trust Fund. In one instance, a state agency waited nearly two years before depositing approximately $2.1 million of its federal receipts into the Federal Trust Fund. In another instance, a state agency, with the approval of the Department of Finance, did not deposit into the State's Federal Trust Fund the $8.1 million that it had received under a federal program. To qualify for this program, the State had to agree to establish a special fund in which to deposit all moneys received under this program. The State established the special fund to meet this qualification and the state agency deposited the $8.1 million directly into this fund, rather than depositing the money first into the Federal Trust Fund and then transferring it to the special fund. However, the law establishing this special fund does not state that the agency should deposit federal receipts directly into the special fund, only that the agency may accept federal contributions to the fund.

Ineligibility for Certificate of Achievement

The State does not yet qualify for the Certificate of Achievement for Excellence in Financial Reporting. The Certificate of Achievement Program of the Government Finance Officers Association encourages and recognizes excellence in financial reporting by governments. The State does not qualify for the certificate primarily for three reasons: it does not produce audited financial statements within six months of the end of the fiscal year, its audited financial statements do not include combining statements by fund type, and it does not properly account for fixed assets. We discussed these weaknesses in the preceding sections.

Inadequate Control Over Some Contracts

Grants and certain contracts and interagency agreements are not routed through the Department of General Services. The State Administrative Manual, Section 1203, requires only those contracts requiring the Department of General Services' approval to be transmitted to the Department of General Services. Grants of state funds are not subject to approval by the Department of General Services. Since some agencies consider certain contracts to be grants, they conclude that these contracts also do not require the approval of the Department of General Services. As a result, grants of state funds and some contracts and interagency agreements go directly from the originating agency to the State Controller's Office, thus, the State Controller's Office does not have assurance that these grants, contracts, and interagency agreements are valid. This weakness would be minimized by having the Department of General Services act as a clearinghouse for all grants, contracts, and interagency agreements. As part of the clearinghouse function, the Department of General Services should establish a statewide vendor list that would contain all entities with which the State contracts. The State Controller's Office would then have more assurance that the grants, contracts, and interagency agreements it receives from the Department of General Services are valid.

In addition, certain contracts between the State and local governments for grants are not being approved by the Department of General Services. Various state agencies believe these contracts are not subject to the Department of General Services' approval. Certain departments have received and relied on legal opinions from the Attorney General's Office and their own departmental legal counsel in determining whether these types of contracts are subject to the Department of General Services' approval. Based on its interpretation of the present rules, the Attorney General's Office has determined that contracts for grants of federal funds and contracts for grants of state funds are not required to be approved by the Department of General Services.

Whether or not a contract with a local government involves a grant of state or federal funds, we believe that there is a weakness in the State's control over these types of contracts by not having them approved by the Department of General Services. Therefore, we recommend that the Department of Finance clarify the sections of the State Administrative Manual regarding contract approval requirements. Specifically, contracts for grants of either state or federal funds to local governments should be subject to the same approval requirements established in the State Administrative Manual for other types of contracts.

Failure To Account for Expenditures of Federal Moneys by Each Federal Program

The State's method of accounting for federal assistance does not provide sufficient information on expenditures of federal moneys because it does not record its expenditures by federal program. We reported a similar weakness in the last four fiscal years. As a result, the State is not able to present a schedule of federal assistance that shows total expenditures for each federal assistance program; therefore, the State is not in compliance with OMB, Circular A-128. The schedule of federal assistance that we present, beginning on page 335, shows total receipts rather than expenditures.

The OMB, Circular A-128, requires the State to submit an audit report on a schedule of federal assistance that shows the total expenditures for each federal assistance program. The California Government Code, Section 13300, assigns the Department of Finance the responsibility for establishing and supervising a complete accounting system to ensure that all revenues, expenditures, receipts, disbursements, resources, obligations, and property of the State are properly accounted for and reported.

Improper Omissions From the State Reporting Process

As we have reported for the last two fiscal years, District Agricultural Associations, which are organized to hold fairs and expositions, are not treated as part of the state reporting entity. To determine whether the District Agricultural Associations should be treated as such, we requested a legal opinion from the Legislative Counsel. The Legislative Counsel found that the District Agricultural Associations are state agencies and that moneys they spend are state funds. Further, funds for support of the District Agricultural Associations are appropriated in the State's annual budget. For these reasons, the Legislative Counsel concluded that the State Controller's Office is required to include the financial information of the District Agricultural Associations in the State's general purpose financial statements. Currently, this financial information is not included, and as a result, the State's general purpose financial statements are incomplete.

Failure to Require Agencies To Submit Reconciliations

For approximately 230 funds numbered 500 to 699 and 800 to 999, the State Administrative Manual, Section 7951, does not require agencies to prepare Report 15, Reconciliation of Agency Accounts With Transactions Per State Controller. As a result, the State Controller's Office does not have evidence that agencies have reconciled financial information that appears in the general purpose financial statements with records of the State Controller's Office. We reported a similar weakness in our audits for the last four fiscal years.

The State Administrative Manual, Section 7900, discusses the importance of making regular reconciliations. Reconciliations represent an important element of internal control because they provide a high level of confidence that transactions have been processed properly and that the financial records are complete. The reconciliation with the records of the State Controller's Office is an important step in ensuring the accuracy of the agencies' financial statements.

Failure To Require Agencies To Prepare a Report of Accruals

The State Administrative Manual, Section 7951, does not require agencies to prepare Report 1, Report of Accruals to the Controller's Accounts, for funds numbered 500 to 699 and 800 to 999. Included among these funds are more than 67 that had budget appropriations for fiscal year 1989-90. As a result of not preparing this report, information needed to distinguish encumbrances from accounts payable and to present financial information in accordance with GAAP is not available for all funds. We reported a similar weakness in our audits for the last four fiscal years.

The California Government Code, Section 12460, requires the State Controller's Office to present the State's financial position in a format that is as close as possible to GAAP. State agencies submit financial reports to the State Controller's Office, which then issues the financial report presenting the State's financial position. In addition, Section 1100.101 of the Governmental Accounting and Financial Reporting Standards, issued by the Governmental Accounting Standards Board, requires that agencies' accounting systems make it possible to present fairly the agencies' financial position and results of operations in accordance with GAAP.

Summary of Audit Results by Area of Government

Summary The State of California continues to face unnecessary costs and the reduced efficiency and effectiveness of its operations because of weaknesses in its internal control structure. Although the State has corrected some of the problems we observed in previous years, the State can still significantly improve its accounting and administrative control structure.

Table 1, which begins on page 22, shows the distribution by state agency of weaknesses in control over financial activities and weaknesses in compliance with state and federal regulations. A more detailed table for weaknesses in federal compliance begins on page 363. The page number column in Table 1 provides the location of our management letter for the indicated state agency. The numbers in the other columns provide the number of occurrences of each weakness as presented in the agencies' management letters.

Beginning on page 25, we present a summary of the most significant findings by area of government. At the beginning of each section, we present additional information regarding audit work performed.

Table 1

Weaknesses in Internal Control Structure

Agency	Page Number	Number of Occurrences[a]: Financial Reporting Activities	Revenue Activities	Expenditure Activities	Electronic Data Processing Activities	Compliance With Federal Regulations[b]	Compliance With State Regulations
BUSINESS, TRANSPORTATION AND HOUSING							
Housing and Community Development, Department of	55	1		1		4	
Insurance, Department of	63			1			
Motor Vehicles, Department of	65	1	2	1	2		
Stephen P. Teale Data Center	75	4	1	2		1	1
Transportation, Department of	88		4	2		2	
EDUCATION							
California Community Colleges, Chancellor's Office	97	4	2	6		1	2[c]
California State University	115		1	4			1
California Student Aid Commission	121					8	
Education, California State Department of	133	1	3	2		8	4
GENERAL GOVERNMENT							
Administrative Law, Office of[d]	153		1			1	1
Chiropractic Examiners, Board of[d]	155		2				
Control, State Board of	159					1	1

Footnotes are presented on page 24

Agency	Page Number	Number of Occurrences[a] Financial Reporting Activities	Revenue Activities	Expenditure Activities	Electronic Data Processing Activities	Compliance With Federal Regulations[b]	Compliance With State Regulations
GENERAL GOVERNMENT (Continued)							
Criminal Justice Planning, Office of	161		1			1	
Economic Opportunity, Department of	165		1			2	
Finance, Department of	169						3
HEALTH AND WELFARE							
Aging, Department of	179			1		1	
Alcohol and Drug Programs, Department of	181		1	1		5	
Employment Development Department	188	1	1	1		3	
Health and Welfare Agency Data Center	194					1	
Health Services, Department of	197		4	3		6	
Mental Health, Department of	212			3		2	
Rehabilitation, Department of	218					6	
Social Services, Department of	225	1	1	1		8	2[c]
LEGISLATIVE, JUDICIAL, AND EXECUTIVE							
Emergency Services, Office of	245					2	
Equalization, Board of	247				1		
Health and Welfare Agency	249					1	

Footnotes are presented on page 24

Agency	Page Number	Number of Occurrences[a]					
		Financial Reporting Activities	Revenue Activities	Expenditure Activities	Electronic Data Processing Activities	Compliance With Federal Regulations[b]	Compliance With State Regulations
LEGISLATIVE, JUDICIAL, AND EXECUTIVE (Continued)							
State Treasurer's Office	250	2					
RESOURCES							
Water Resources, Department of	255	2		2			
STATE AND CONSUMER SERVICES							
Franchise Tax Board	263	2	7	1	1		1
General Services, Department of	290	7	3	2		1	2
Public Employees' Retirement System	316						1
YOUTH AND ADULT CORRECTIONAL							
Corrections, Department of	319			2			1[c]
Youth Authority, Department of the	323			2		1	1[c]

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

[b]The table on page 363 provides more detail regarding the weaknesses in compliance with federal regulations.

[c]These items include deficiencies in administering state contracts. Table 2 on page 49 provides further detail of these deficiencies.

[d]We audited the financial operations of these agencies for fiscal year 1988-89; however, we issued the audit results after we issued the State of California Comprehensive Financial and Compliance Audit Report Year Ended June 30, 1989.

Business, Transportation and Housing

In fiscal year 1989-90, the State spent more than $5 billion, approximately 6 percent of the State's expenditures, on programs in the Business, Transportation and Housing Agency. The agency oversees the operations of 19 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 5 departments: the Department of Housing and Community Development, the Department of Insurance, the Department of Motor Vehicles, the Stephen P. Teale Data Center, and the Department of Transportation. We also audited three federal programs with receipts of approximately $1.3 billion for compliance with federal regulations. We have issued 12 special topic reports that include issues relating to Business, Transportation and Housing programs since July 1989. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 5 departments within the Business, Transportation and Housing Agency. In the following section, we discuss the most significant weaknesses we reported.

Department of Motor Vehicles

The Department of Motor Vehicles (department) does not have sufficient control over the collection of dishonored checks. As of June 30, 1990, the department had approximately $10.2 million in checks that banks had not honored. Two of the three units within the department responsible for collecting dishonored checks were not notifying the revenue collection unit when they received payment on these checks. As a result, the collection was treated as a revenue rather than a collection of a dishonored check. In addition, none of the three units notified the revenue collection unit when they determined that certain checks were not collectible. Consequently, these uncollectible checks were not included in other programs such as the Franchise Tax Board's Offset program, which is designed to offset the amount owed to a state agency by the person who paid the dishonored check by reducing the individual's tax refund for the amount of the check. Finally, a unit routinely waives penalties that are assessed against uninsured motorists involved in an accident when the penalty is paid with a dishonored check. Thus, the department is not only waiving this penalty, it is also forfeiting an unspecified amount of revenue it could be collecting.

In addition, the department's electronic data processing personnel did not adequately test changes made to certain programs prior to implementing the programs. Because of inadequate testing, in one instance, the department estimates that it incurred an additional expenditure of $200,000 to send out new bills and that it lost approximately $60,000 in revenue. In another instance, since August 1989, the lack of adequate testing caused the accounting unit to use an indeterminable number of staff hours to prepare daily reconciliations that normally would not be necessary.

Stephen P. Teale Data Center

The Stephen P. Teale Data Center (data center) has weaknesses in its control over and accounting for equipment and intangible assets. For example, the data center has not taken a complete physical inventory of its equipment within the last three fiscal years, nor has it maintained a comprehensive inventory listing of equipment it has retired from use and stored in its warehouse. Further, the data center did not always identify equipment it had purchased and did not always attach a tag with a state identification number to this equipment. Finally, the data center equipment identification numbers listed in its accounting records did not always agree with the identification number assigned to the equipment. The data center's failure to maintain sufficient controls over its equipment prevents prompt detection of errors and exposes state property to increased risk of loss.

The data center's weaknesses in accounting for equipment and intangible assets resulted in incorrect account balances. Specifically, the data center did not remove from its equipment balance at June 30, 1990, ten items of equipment valued at approximately $1.4 million that it had sold or had removed from service before the end of the fiscal year. The data center also recorded the costs of the software it purchased as an operating expense rather than as an intangible asset. State regulations require state agencies to record certain software costs as intangible assets and to systematically allocate to expenses the cost of the software over its useful life. Because the data center recorded its software purchases as an expense, it overstated its operating expenses for fiscal year 1989-90 by approximately $1.3 million. In addition, the data center had not recorded intangible assets of approximately $4.5 million as of June 30, 1990.

Education

In fiscal year 1989-90, the State spent more than $35.6 billion, approximately 44 percent of the State's expenditures, on education programs. This area of government consists of 16 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 4 departments: the California Community Colleges, Chancellor's Office; the California State University; the California Student Aid Commission; and the California State Department of Education. We also audited 13 federal programs with receipts of approximately $1.8 billion, and other independent auditors audited one federal program with receipts of approximately $84 million for compliance with federal regulations. Further, we have issued ten special topic reports that include issues relating to education programs since July 1989. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 4 departments within the area of education. In the following section, we discuss the most significant weakness we reported.

California Community Colleges, Chancellor's Office

The California Community Colleges, Chancellor's Office (Chancellor's Office) needs to improve controls over its cash management system for requesting federal funds. The Chancellor's Office did not promptly request federal funds to reimburse the State for local assistance expenditures, resulting in a loss of approximately $38,000 in potential interest income.

General Government

In fiscal year 1989-90, the State spent more than $3.3 billion, approximately 4 percent of the State's expenditures, on general government. This area of government consists of 50 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 7 departments: the State Public Defender, the Office of Criminal Justice Planning, the Board of Chiropractic Examiners, the Department of Economic Opportunity, the Department of Finance, the Board of Control, and the Office of Administrative Law. We also audited two federal programs with receipts of approximately $72.9 million for compliance with federal regulations. We have issued seven special topic reports that include issues relating to general government since July 1989. These special topic reports required our office to review the selected operations of seven additional entities: the Agricultural Labor Relations Board, the California Arts Council, the California Exposition and State Fair, the California Horse Racing Board, the Department of Food and Agriculture, the Military Department, and the Public Utilities Commission. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 6 of the departments that we audited within the area of general government. See Table 1 on page 22 for the classification of these weaknesses.

Health and Welfare

In fiscal year 1989-90, the State spent more than $27.3 billion, approximately 34 percent of the State's expenditures, on programs in the Health and Welfare Agency. The agency oversees the operations of 18 departments and other budgeted activities. In addition to our centralized testing, our financial and compliance audit focused on 9 departments: the Department of Aging, the Department of Alcohol and Drug Programs, the Department of Developmental Services, the Employment Development Department, the Health and Welfare Agency Data Center, the Department of Health Services, the Department of Mental Health, the Department of Rehabilitation, and the Department of Social Services. We also audited 24 federal programs with receipts of approximately $9.6 billion for compliance with federal regulations. Further, we have issued 14 special topic reports that include issues relating to Health and Welfare Agency programs since July 1989. These special topic reports required our office to review the selected operations of one additional entity, the Office of Statewide Health Planning and Development. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 8 departments within the Health and Welfare Agency. In the following section, we discuss the most significant weaknesses we reported.

Department of Health Services

The Department of Health Services (department) has numerous weaknesses in its administration of its federal programs. For example, for each month of fiscal year 1989-90, the department was late in completely reconciling the food vouchers it issued with the food vouchers redeemed by participants in the federal Special Supplemental Food Program for Women, Infants and Children. Additionally, the department has not fully implemented a cost avoidance system to avoid paying Medi-Cal claims for beneficiaries who have other health care coverage. Further, the State lost approximately $645,500 in potential interest earnings during fiscal year 1989-90 because the department delayed in requesting federal reimbursements for four grant programs.

Department of Social Services

The Department of Social Services (department) does not always properly control its cash management system for requesting federal funds for the federal share of the department's local assistance expenditures. For example, the department did not promptly request federal funds to reimburse the State for local assistance expenditures, resulting in the loss of approximately $1.2 million in potential interest income. Further, in September 1989, the department received approximately $5 million in federal funds for county food stamp expenditures for federal fiscal year 1987-88. However, the department did not release the funds to the counties until October 1990.

Legislative, Judicial, and Executive

In fiscal year 1989-90, the State spent more than $1.8 billion, approximately 2 percent of the State's expenditures, on the legislative, judicial, and executive area of government. This area of government consists of 34 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 5 departments: the Office of Emergency Services, the Board of Equalization, the Health and Welfare Agency, the State Controller's Office, and the State Treasurer's Office. We also audited two federal programs with receipts of approximately $75.4 million for compliance with federal regulations. Further, we have issued five special topic reports that include issues relating to the legislative, judicial, and executive areas of government since July 1989. These special topic reports required our office to review the selected operations of one additional entity, the Department of Justice. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 4 departments within the legislative, judicial, and executive areas of government. See Table 1 on page 22 for the classification of these weaknesses.

Resources

In fiscal year 1989-90, the State spent more than $2.2 billion, approximately 3 percent of the State's expenditures, on programs in the Resources Agency. The agency oversees the operations of 24 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 2 departments: the State Lands Commission and the Department of Water Resources. Further, we have issued three special topic reports that included issues relating to programs in the Resources Agency since July 1989. These special topic reports required our office to review the selected operations of four additional entities: the California Waste Management Board, the Department of Fish and Game, the Department of Parks and Recreation, and the State Water Resources Control Board. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for one department within the Resources Agency. See Table 1 on page 22 for the classification of these weaknesses.

State and Consumer Services

In fiscal year 1989-90, the State spent more than $2.2 billion, approximately 3 percent of the State's expenditures, on programs in the State and Consumer Services Agency. The agency oversees the operations of 12 departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 3 departments: the Franchise Tax Board, the Department of General Services, and the Public Employees' Retirement System. We also have issued seven special topic reports that include issues relating to programs for the State and Consumer Services Agency since July 1989. These special topic reports required our office to review the selected operations of three additional entities: the Contractors' State License Board, the Museum of Science and Industry, and the State Board of Barber Examiners. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 3 departments within the State and Consumer Services Agency. In the following section, we discuss the most significant weaknesses we reported.

Franchise Tax Board

The Franchise Tax Board (board) does not have all the necessary procedures in all units to prevent erroneous tax refunds or erroneous billings to bank and corporate taxpayers. Specifically, the board does not always require its staff to review the calculations of refunds or billings sent to taxpayers, it does not have procedures to ensure that it does not send out duplicate refunds, it does not always have effective reviews to prevent large errors from being posted to taxpayers' accounts, and it does not have procedures to inform employees of how unusual federal tax credits affect state tax calculations. As a result, the board overpaid approximately $25 million in tax refunds to seven taxpayers, it delayed collecting revenue totaling approximately $882,000, it did not bill two taxpayers for approximately $47,600, it underpaid three taxpayers by approximately $56,000, and it overbilled two taxpayers by approximately $1 million. Although all of the duplicate refunds paid by the board were returned by the taxpayers, the board should implement effective procedures to prevent similar errors.

The board has not sufficiently resolved weaknesses in its bank and corporation tax system that were identified by the board's internal audit unit. As a result of the insufficient resolution of the weaknesses, the board cannot ensure that all banks and corporations are receiving the refunds that they are legally entitled to receive.

Youth and Adult Correctional

In fiscal year 1989-90, the State spent more than $2.5 billion, approximately 3 percent of the State's expenditures, on programs in the Youth and Adult Correctional Agency. The agency oversees the operations of six departments and other budgeted activities. In addition to our centralized testing and the audits performed by other independent auditors, our financial and compliance audit focused on 3 departments: the Board of Corrections, the Department of Corrections, and the Department of the Youth Authority. We also have issued two special topic reports that include issues relating to programs for the Youth and Adult Correctional Agency since July 1989. These special topic reports required our office to review the selected operations of four additional entities: the California Institution for Men, the California Rehabilitation Center, the California State Prison at Folsom, and the Sierra Conservation Center. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1989, to December 31, 1990).

We reported weaknesses for 2 departments within the Youth and Adult Correctional Agency. See Table 1 on page 22 for the classification of these weaknesses.

Report on the Study and Evaluation of Internal Controls

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State of California
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Independent Auditors' Report

Members of the Joint Legislative Audit Committee
State of California

We have audited the general purpose financial statements of the State of California as of and for the year ended June 30, 1990, and have issued our report thereon dated December 14, 1990. We did not audit the financial statements of the pension trust funds, which reflect total assets constituting 78 percent of the fiduciary funds. We also did not audit the financial statements of certain enterprise funds, which reflect 92 percent of the total assets and 96 percent of the total revenues of the enterprise funds. In addition, we did not audit the University of California funds. We did not audit the financial statements of these pension trust funds, these enterprise funds, and the University of California funds because they were audited by other independent auditors. We have also audited the State of California's compliance with requirements applicable to major federal financial assistance programs and have issued our report thereon dated February 15, 1991.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the federal Office of Management and Budget (OMB), Circular A-128, *Audits of State and Local Governments*. These standards and OMB, Circular A-128, require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement and about whether the State of California complied with laws and regulations, noncompliance with which would be material to a major federal financial assistance program.

In planning and performing our audit for the year ended June 30, 1990, we considered the State of California's internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on the State of California's general purpose financial statements and on its compliance with requirements applicable to major federal financial assistance programs and not to provide assurance on the internal control structure.

The Department of Finance and the agencies' management are responsible for establishing and maintaining an internal control structure. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of general purpose financial statements in accordance with generally accepted accounting principles, and that federal financial assistance programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories: financial activities, including electronic data processing controls; state compliance; and federal compliance. We did not study the internal control structures for the pension trust funds, certain enterprise funds, and the University of California funds.

During the year ended June 30, 1990, the State of California received 96 percent of its total federal financial assistance under major federal financial assistance programs. We performed tests of controls, as required by OMB, Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the State of California's major federal financial assistance programs. These major federal financial assistance programs are identified in the accompanying Schedule of Federal Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted a material weakness in the State's accounting for general fixed assets that we consider to be a reportable condition under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the State's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general purpose financial statements or to administer federal financial assistance programs in accordance with applicable laws and regulations. Our study and evaluation and our audit disclosed no condition that we believe to be a material weakness in relation to a federal financial assistance program of the State.

Weakness in Accounting for General Fixed Assets

The State does not maintain sufficient records to support the cost of general fixed assets. Furthermore, the State does not record all fixed assets in the property records. This weakness in accountability results in an increased risk of loss of assets. Furthermore, it makes it impossible for the State Controller's Office to present the General Fixed Assets Account Group in the general purpose financial statements.

Recommendation

The Department of Finance should require all agencies to comply with property accounting procedures that would allow the State Controller's Office to include the General Fixed Assets Account Group in the general purpose financial statements. Complying with property accounting procedures would assist in safeguarding the assets of the State.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general purpose financial statements being audited or the risk that noncompliance with laws or regulations that would be material to a federal financial assistance program may occur and not be promptly detected by employees in the normal course of performing their assigned functions.

While our study did not disclose any other material weaknesses, it did disclose certain matters involving the internal control structure, including the applicable internal administrative controls used in administering federal financial assistance programs, that require the attention of management. The remaining sections of this report will discuss these conditions.

This report is intended for the information of the California Legislature, including the Joint Legislative Audit Committee, and the management of the executive branch. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the Joint Legislative Audit Committee, is a matter of public record.

OFFICE OF THE AUDITOR GENERAL

CURT DAVIS, CPA
Deputy Auditor General

February 15, 1991

Detailed Description of Weaknesses at State Agencies

Index

Deficiencies Common to Various Agencies

Summary

Certain deficiencies in internal control are common to more than one agency. For example, many state agencies do not comply with the California Public Contract Code in establishing and maintaining contracts with vendors. In addition, not all state agencies promptly return undelivered salary warrants to the State Controller's Office.

We discovered these and other deficiencies when we performed our annual financial and compliance audit of the State. We have reported these systemic deficiencies to the Department of Finance, which is the agency that has general supervisory responsibility over all matters concerning the financial and business policies of the State. In the following paragraphs, we discuss the deficiencies we found.

Deficiencies in Administering State Contracts

State agencies do not always comply with the California Public Contract Code in establishing and maintaining contracts with vendors. During statewide testing at 17 agencies comprising a total of 180 contracts, we found 100 contracts that did not fully comply with provisions of the Public Contract Code. For example, 44 contracts were not approved before the beginning of the contract work. If these contracts had not been approved, the State might still have been liable for the work performed and might have incurred litigation costs regarding the State's obligation to pay for that work. State agencies also did not always review contractor evaluation forms on file with the Department of

General Services or, if the contractor had not had a previous contract with the State, they did not include in the contract file a resume of the contractor's major personnel before approving 22 of the contracts we reviewed. Furthermore, 46 contract files did not contain a contractor evaluation form prepared within 30 days of completing the contract, and 7 contracts lacked other documentation. Failure to review or prepare contractor evaluations may cause the State to enter into contracts with unreliable vendors. Although legislation in effect for fiscal year 1989-90 required that state agencies prepare a contractor evaluation form for all contracts, state agencies will be required as of September 1990 to prepare the contractor evaluation form only for consulting services contracts. Finally, 15 contracts failed to comply with other provisions of the Public Contract Code. Table 2, page 49, provides details of the deficiencies in administering state contracts at various agencies for fiscal year 1989-90.

Sections 10295, 10335, 10360, and 10364 of the Public Contract Code state that all state contracts, unless exempt under these sections, must contain the required documentation and are void unless and until approved. The State Administrative Manual, Section 1209, emphasizes the need for contract approval before the beginning of the contract work. Section 10371(e) of the Public Contract Code requires each state agency, when contracting for consultant services, to review the contractor evaluation form on file with the Department of General Services, or, if the contractor has not had a previous contract with any state agency, the state agency must include a resume of the major contract participants in the contract file. In addition, Sections 10347(a) and 10369 of the Public Contract Code require each state agency to conduct, within 30 days of completion of a contract, an evaluation of each contract awarded. Sections 10300 through 10334 and Section 10371 of the Public Contract Code discuss other required state contracting provisions, such as competitive bidding procedures.

Table 2

Deficiencies in Administering State Contracts at Various Agencies
Fiscal Year 1989-90

Agency	Number of Contracts Reviewed	Number of Contracts Reviewed With at Least One Deficiency	Lack of Approval Before Start of Contract Work	Lack of Review of Post-Contract Evaluation or Resume Before Contract Approval	Lack of Prompt Post-Contract Evaluations	Lack of Required Documentation (Except Evaluations)	Lack of Other Required Procedures
California Community Colleges, Chancellor's Office	10	7	2	5	0	0	1
California Exposition and State Fair	10	10	9	0	6	5	0
Corrections, Department of	10	8	2	1	8	0	0
Education, California State Department of	10	6	0	6	2	0	0
Employment Development Department	10	2	2	0	0	0	1
Equalization, Board of	10	6	2	0	0	0	4
Franchise Tax Board	10	5	0	0	1	0	5
General Services, Department of	20	3	0	0	1	2	1
Health Services, Department of	10	8	4	2	6	0	1
Mental Health, Department of	10	5	3	4	1	0	0
Motor Vehicles, Department of	10	7	5	0	5	0	0
Social Services, Department of	10	9	4	1	4	0	0
State Controller's Office	10	1	0	0	0	0	1
State Treasurer's Office	10	9	9	0	0	0	0
Transportation, Department of	10	1	0	0	0	0	1
Water Resources, Department of	10	6	0	2	4	0	0
Youth Authority, Department of the	10	7	2	1	8	0	0
Total	180	100	44	22	46	7	15

Salary Warrants are not Always Promptly Returned

State agencies do not always return undelivered salary warrants to the State Controller's Office within 90 calendar days of receipt. We performed tests for undelivered salary warrants more than 90-days old at 63 locations and found that 18 locations did not return a total of 184 salary warrants to the State Controller's Office within 90 days of receipt. These warrants ranged in amount from $0.41 to $4,551.53. The oldest warrant found was dated December 27, 1985, and amounted to $55.74. Failure to return the undelivered warrants to the State Controller's Office increases the risk of their loss or misappropriation. Table 3 below provides, by agency, the number of undelivered salary warrants that were more than 90-days old.

The State Administrative Manual, Section 8580.5, specifies that salary warrants not delivered within 90 calendar days of receipt must be returned to the State Controller's Office for monthly deposit in the special deposit fund.

Table 3 **Salary Warrants Not Returned Within 90 Days**

Agency	Number of Warrants More Than 90-Days Old
California State University (Six campuses)	48
Corrections, Department of (One institution)	2
Developmental Services, Department of (Three hospitals)	20
Fish and Game, Department of	4
Franchise Tax Board	3
Insurance, Department of	20
Mental Health, Department of (Two hospitals)	18
Motor Vehicles, Department of	57
Transportation, Department of (One district)	2
Water Resources, Department of	10
Total	184

Management Letters by Area of Government

Business, Transportation and Housing

Department of Housing and Community Development

We reviewed the Department of Housing and Community Development's (department) administration of the U.S. Department of Housing and Urban Development grants, Federal Catalog Numbers 14.156 and 14.228.

Performance Report Not Supported by Subgrantee Information

Finding

The annual performance report that the department prepared for fiscal year 1989-90 was not fully supported by information received from subgrantees of the Community Development Block Grant program. For three of the ten subgrantees that we reviewed, the department's performance report contained incorrect expenditure information. In addition, the department omitted from the performance report the expenditure information for another subgrantee that we reviewed. Because of these errors, the department reported grant expenditure information that was $19,030 less than reported by the subgrantees that we reviewed. Moreover, the department was 29 days late in submitting to the federal government its annual performance report for fiscal year 1989-90. Failure to correctly prepare and promptly submit the performance report may adversely affect the federal government's evaluation of the program. We reported a similar weakness in our compliance audit for fiscal year 1987-88.

Criteria

The Code of Federal Regulations, Title 24, Section 570.498, requires a state administering Community Development Block Grant funds to submit an annual performance report in such a form and including such information as the state deems appropriate and sufficient to meet the requirements of the federal government. Good accounting practice dictates that this information be complete and accurate. In addition, Section 570.498 requires the state to submit the report by October 1 of each year.

Recommendation

The department should prepare its annual performance report by using the appropriate information from subgrantee reports. In addition, the department should submit to the federal government its annual performance report by the required due date.

Subgrantee Reporting Requirements Not Enforced

Finding

Our review of ten subgrantees of the Community Development Block Grant program found that four of the subgrantees were between 2 and 276 days late in submitting their quarterly narrative reports, and two subgrantees had not submitted their quarterly narrative reports that were due on April 30,1990. In addition, as of the close of our review on January 24, 1991, three of the ten subgrantees had not submitted annual performance reports that were due on July 31, 1990. Reports that are late or not submitted reduce the department's control over the subgrantees' performance and delay the State's submission of its annual performance report to the federal government.

We reported a similar weakness in our compliance audits for fiscal years 1985-86, 1986-87 and 1987-88. Although the department has procedures to ensure that subgrantees comply with reporting requirements, the department has not been able to fully implement the procedures because of a shortage of staff.

Criteria

The Code of Federal Regulations, Title 24, Section 570.498, requires a state that administers Community Development Block Grant funds to submit an annual performance report in such a form and including such information as the state deems appropriate and sufficient to meet the requirements of the federal government. To prepare this report, the state requires subgrantees to submit information concerning projects. Further, the California Code of Regulations, Title 25, Section 7108 (e), requires that subgrantees file quarterly reports within 30 days after the end of the quarter. In addition, the department's Grant Management Manual, Chapter III-III-A., requires grantees to submit their annual reports no later than July 31st of each year.

Recommendation

The department should ensure that subgrantees submit their quarterly narrative reports and annual performance reports by the required due dates.

Insufficient Monitoring of Subgrantees

Finding

The department did not sufficiently monitor subgrantees of the Community Development Block Grant program. Specifically, the department did not have a system to follow up on independent audit reports of subgrantees and had weaknesses in its monitoring of subgrantees. Without proper monitoring, the department lacks assurance that the subgrantees are complying with federal requirements and that audit findings are resolved promptly. We noted the following deficiencies:

- The department did not review the independent audit reports of subgrantees and did not have a system to follow up on the audit findings in these reports for fiscal year 1989-90. As a result, the department could not ensure that the subgrantees corrected the problems in the audit findings reported by independent auditors.

- The department had weaknesses in its monitoring of subgrantees of the Community Development Block Grant program. For one of the six subgrantees that we reviewed, the department did not communicate the results of its monitoring review to the subgrantee until five months after the review was concluded. Further, we could not find any evidence that the department communicated in writing the results of its monitoring review of another subgrantee.

Criteria

The Code of Federal Regulations, Title 24, Section 44.11, requires the department to ensure resolution of audit findings within six months after receipt of the report by the federal agency. Policy memoranda from the U.S. Department of Housing and Urban Development require the department to perform on-site monitoring reviews of subgrantees and to communicate to subgrantees the results of the monitoring reviews. In addition, the department's Program Monitoring Handbook for the Community Development Block Grant program requires monitoring conclusions to be communicated in writing to subgrantees no later than 45 days after the review is concluded.

Recommendation

The department should implement a system to ensure that it follows up on all independent audit reports of subgrantees of the Community Development Block Grant program and that it takes appropriate and prompt action to resolve audit findings reported by independent auditors. The department should promptly communicate in writing to subgrantees the conclusions of its monitoring reviews.

Weaknesses in Control Over the Revolving Fund

Finding

The department has weaknesses in control over its revolving fund. For fiscal year 1989-90, we noted the following deficiencies:

- For each of the 12 months in fiscal year 1989-90, the department overdrew its revolving fund by an average balance of approximately $9.3 million. At June 30, 1990, the revolving fund was overdrawn by $7,935,664. These overdrafts occurred primarily because the department did not promptly submit to the State Controller's Office requests to reimburse its revolving fund. When the department overdraws its revolving fund, it must finance the overdrafts with monies from other funds or from cash receipts not yet accounted for in a fund. Financing overdrafts with monies from other funds or other cash receipts weakens controls over these monies.

- The department did not promptly request reimbursement for its revolving fund. As of June 30, 1990, the department reported unreimbursed travel and expense advances totaling approximately $2.1 million. Of this amount, approximately

$1.1 million, or 52 percent, had been outstanding for at least four months. Also, in our review of 23 revolving fund payments, we found that the department took an average of 154 days to request reimbursement from the State Controller's Office for the revolving fund payments. In particular, the department took approximately 18 months to request reimbursement for one revolving fund payment and at least five months to request reimbursement for seven other payments. Finally, although the department knew that it did not have sufficient funds to reimburse its revolving fund, it made a payment of approximately $1.3 million from its revolving fund in June 1990. As of the close of our review on February 26, 1991, the department had not requested or received reimbursement for this payment.

- The department improperly used its revolving fund to pay for acquisition of property and to pay some vendor invoices. For 11 of the 23 revolving fund payments that we reviewed, the department made payments by revolving fund check rather than using the normal claims processing procedure through the State Controller's Office, even though immediate payment was not necessary. Improper use of the revolving fund circumvents state controls over disbursements and could result in a misuse of state funds.

- For each of the 12 months during fiscal year 1989-90, the department did not reconcile revolving fund resources with cash advanced to the revolving fund. However, the department did prepare the year-end analysis and reconciliation of the revolving fund as of June 30, 1990. Failure to reconcile monthly the revolving fund resources with the cash advanced can prevent prompt detection of errors and irregularities.

We reported similar weaknesses in the department's control over the revolving fund in our audit for fiscal year 1987-88. Although weaknesses still exist, the department has taken actions to improve control over the revolving fund. In May 1990, the department's director formally instructed staff to discontinue the use of the revolving fund for purposes other than those allowed by the State Administrative Manual. In addition, according to the chief of the department's fiscal operations branch, the department recently made staffing changes to strengthen controls over the revolving fund and to eliminate the overdrafts in the revolving fund. As of February 15, 1991, the department reported that it had reduced the revolving fund deficit to $835,594.

Criteria

The State Administrative Manual, Section 8047, requires agencies to make every effort to prevent overdrafts. In particular, these efforts include the prompt scheduling of claims to reimburse the revolving fund. In addition, the State Administrative Manual, Section 8110, states that the permissible uses of revolving funds include paying for compensation earned, travel expenses and travel expense advances, and immediate payments when necessary. Further, the State Administrative Manual, Section 8113, states that if time permits, agencies should always submit claims for vendor invoices to the State Controller's Office for payment by warrant. Finally, the State Administrative Manual, Section 8193 and Section 7964, requires agencies to prepare a monthly reconciliation of revolving fund resources with cash advanced to the revolving fund.

Recommendation

The department should continue its efforts to eliminate the overdrafts in its revolving fund. To prevent future overdrafts in the revolving fund, the department should promptly submit claims to reimburse the revolving fund. In addition, the department should use the revolving fund only for authorized purposes. Finally, the department should prepare revolving fund reconciliations promptly at the end of each month.

Noncompliance With Federal and State Requirements

Findings and Criteria

We noted the following instances where the department did not always comply with administrative requirements of the federal government and the State:

- For one of ten subgrantees of the Community Development Block Grant program that we reviewed, the department released federal funds to the subgrantee before the end of the required waiting period for environmental review comments from the public. In addition, the department did not obtain from another subgrantee the necessary approvals on a document for exemption from environmental review. Failure to comply with requirements for environmental review may result in the department's funding projects that have significant adverse effects on the environment and that are inconsistent with federal environmental programs and policies. The California Code of Regulations, Title 14, Section 15073, and the department's Grant Management Manual, Chapter IV, require subgrantees to make certain environmental review documents available for public comments for 30 days. Further, the Code of Federal Regulations, Title 24, Section 58.73, prohibits the department from releasing federal funds to subgrantees until the later of 15 days from the receipt of the request for release of funds or the time specified in the environmental review document. Finally, the California Code of Regulations, Title 14, Section 15075, requires certain environmental review documents to be filed with the county clerk's office.

- The department did not prepare monthly reconciliations of the CALSTARS Labor Distribution Subsystem. Without these reconciliations, the department lacks assurance that it has correctly recorded its payroll transactions and that its financial records are complete. The CALSTARS Procedures Manual, Volume 4, page V-24, discusses the importance and necessity of preparing the Labor Distribution Subsystem Reconciliation, correcting immediately any errors or discrepancies identified by the reconciliation, and retaining the reconciliation for later audit review.

Although individually these instances of noncompliance may not appear to be significant, any deviation from the State's system of internal controls, or noncompliance with federal regulations, makes the public's resources vulnerable to abuse.

Recommendation

The department should improve its compliance with each of the federal and state requirements.

Department of Insurance

We reviewed the financial operations and related internal controls at the Department of Insurance (department).

Weaknesses in Separation of Duties Over Cash

Finding

The department has weaknesses in its separation of duties for recording and disbursing cash. Failure to maintain proper separation of duties can result in errors and irregularities that may go undetected. We found the following specific deficiencies:

- Two employees who authorize cash disbursements also compare checks with supporting documentation, manually sign checks, have access to blank check stock, and initially record cash receipts and cash disbursements in the department's records;
- One employee authorized to manually sign checks also has access to blank check stock;
- One employee prepares checks and also mails or distributes checks; and
- One employee prepares checks and also reconciles bank accounts.

Criteria

The State Administrative Manual, Section 8080, prohibits one person from performing more than one of the following: authorizing disbursements, preparing checks, manually signing checks after personally comparing them to authorizations and supporting documents, and reconciling bank accounts. This section also prohibits an employee who prepares checks from mailing those checks. In addition, a person who signs or compares checks with supporting documentation should not have access to blank check stock and should not initially record cash receipts and cash disbursements.

Recommendation

The department should reassign duties among employees to provide for adequate separation of duties.

Department of Motor Vehicles

We reviewed the financial operations and related internal controls at the Department of Motor Vehicles (department).

Inadequate Control Over Dishonored Checks

Finding

The department does not have sufficient control over the collection of dishonored checks. As of June 30, 1990, the department had approximately $10.2 million in checks that banks had not honored.

We determined that two of the three units responsible for the collection of dishonored checks were not notifying the revenue collection unit when they received payment on these checks. Thus, these payments were not being processed as collections on dishonored checks. Instead, the payments were being forwarded to the accounting unit and recorded as revenue. As a result of processing payments of dishonored checks as revenue and not updating the dishonored check system, the department is recording revenue twice and overstating the amount of dishonored checks outstanding.

We also found that none of the three units notified the revenue collection unit when they determined that certain checks were uncollectible. Consequently, these uncollectible checks were not deleted from the list of dishonored checks and were not added to the relief of accountability listing that is submitted to the Board of Control for write-off.

Further, because only the revenue collection unit participates in the Franchise Tax Board's Offset Program, which offsets the amount owed to a state agency by reducing an individual's tax refund for the amount owed, the department's use of the program has been limited.

In addition, a unit routinely waives penalties that are assessed against uninsured motorists involved in an accident when the penalty is paid with a dishonored check. The department issues a restricted license, valid for one year, to uninsured motorists who have been involved in an accident. The restricted license is issued when an individual pays a $250 penalty. We determined that when a check for the $250 penalty is not honored by the bank, the unit suspends the restricted license on its computer system. However, it routinely waives the $250 penalty at the end of one year. Thus, the department is not only waiving this penalty, it is forfeiting an unspecified amount of revenue it could be collecting.

Finally, we reviewed 17 checks from the department's listing of dishonored checks. These checks were dated from July 8, 1985, to March 13, 1989. One of the 17 checks had not been added to a list for collection. Further, for 6 checks, totaling $12,722, the department was unable to locate or determine their disposition. For the remaining 10 checks, we determined that collection efforts had been exhausted. However, the department had not submitted the dishonored checks to the Board of Control for write-off or to the Franchise Tax Board for offset. Failure of the department to quickly identify and obtain collection of dishonored checks can reduce the potential for collecting these monies.

These weaknesses have been caused by a lack of centralized control over the collection of dishonored checks. The department has not given primary responsibility for the processing of dishonored checks to one of the four units involved in the collection of dishonored checks. Thus, all four units at the department act independently, which hampers collection efforts.

Criteria

The California Government Code, Section 13403(a)(3), states that the elements of a satisfactory system of internal accounting and administrative control should include, but are not limited to, a system of authorization and recordkeeping procedures that effectively control assets, liabilities, revenues, and expenditures. The California Vehicle Code, Section 16072, states that, in lieu of suspending the driving privilege of a person who has been involved in an accident and has failed to maintain proof of financial responsibility (uninsured motorist), the department may, upon application, restrict the person's driving to necessary travel if the person files and thereafter maintains proof of financial responsibility and pays a penalty to the department of $250.

Recommendation

The department should centralize the process for identifying and collecting dishonored checks. The department should establish written procedures for processing payments received on dishonored checks and ensure that department staff involved in the collection of dishonored checks are aware of these procedures. The department should provide to the Board of Control a listing for checks where collection efforts have been exhausted, and it should attempt collection of all dishonored checks through the Franchise Tax Board's offset program.

Insufficient Documentation of Refunds

Finding

The department does not obtain sufficient documentation to support refunds issued to individuals. The department issues three types of refunds: one type where it issues cash and two types where it issues a check. During fiscal year 1989-90, the department issued refunds totaling approximately $14.5 million by check and an undeterminable number of cash refunds.

We reviewed fifteen refunds where checks were issued. For four of the fifteen refunds, totaling approximately $26,000, at the time of our testing, the department was unable to document why these refunds had been issued. For example, the department received $12,960 for payment of motor vehicle license fees. On the next day, without evidence to support the reason for this refund, the department issued a refund for the entire $12,960.

In addition, we were unable to test cash refunds because the department discards the documents related to cash refunds after five days. Further, because of the lack of documentation, the department was unable to determine the total cash refunds that the department issued in fiscal year 1989-90.

As a result of not obtaining proper documentation or maintaining adequate records to support refunds, the department cannot ensure that all refunds are appropriate and, thus, has made itself susceptible to fraud and abuse.

Criteria

The California Government Code, Section 13403(a)(3), states that the elements of a satisfactory system of internal accounting and administrative control should include, but are not limited to, a system of authorization and recordkeeping procedures that effectively control assets, liabilities, revenues, and expenditures. The California Vehicle Code, Sections 42231 and 42232, state that a person who has paid an erroneous or excessive or not-legally-due amount, may apply for a refund within three years after the date of the payment or collection. Further, the California Vehicle Code, Section 42232, also states that the application for refund shall identify the payment made and state the grounds upon which it is claimed to be excessive or erroneous.

Recommendation

The department should establish procedures to ensure that documentation is obtained that support the refunds issued and should retain this documentation at least three years. If the department does not wish to maintain documentation on cash refunds, the department's internal audit staff should test these cash refunds as part of their field office reviews.

Inadequate Program Testing Prior to Implementation

Finding

The department's Electronic Data Processing (EDP) personnel did not adequately test changes made to certain programs prior to implementing the programs. Because of inadequate testing, in one instance, the department estimates it incurred an additional expenditure of $200,000 to send out new bills and lost approximately $60,000 in revenue. In another instance, since August 1989, the lack of adequate testing caused the accounting unit to use an undeterminable number of staff hours to prepare daily reconciliations that normally would not be necessary.

The department did not fully test a revision to the program used to bill motor vehicle registration fees. In October 1990, the department sent invoices for motor vehicle registration fees to approximately 423,000 individuals. Of these invoices, approximately 396,000 (94 percent) were incorrectly computed. Of the incorrectly computed invoices, approximately 41,000 (10 percent) requested payment for more than what was required, while approximately 355,000 (90 percent) requested payment for less than what was required. For example, 216 individuals were each underbilled more than $1,000, while 16,050 individuals were each overbilled more than $1,000. In another instance, the department overbilled one individual $5,709. The department did not identify the problem until an individual who was overbilled contacted the department. Had the system generated only underbillings, it appears unlikely that the department would have detected the error promptly. Because the department did not fully test the program, the department estimates that it incurred an additional expenditure of $200,000 to send out new bills and lost approximately $60,000 in revenue.

In another instance in August 1989, the department implemented a program to account for cash receipts collected through the mail. The program was designed to automatically update the department's computerized accounting records. However, the program does not accurately record these cash transactions. For the last 16 months, the department's accounting unit has had to reconcile the manually prepared cash accounting records with the computerized cash accounting records to identify reconciling items.

In a batch process program, transactions are accumulated in batches and processed at given intervals or when the batch reaches a certain size. However, the above situations occurred because these batch process programs were not fully tested.

Criteria

The California Government Code, Sections 13401(b)(1) and 13403, require that state agencies establish a system of authorization and recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures. Further, the Information Systems Audit Process guide states that one of the control objectives of the systems-development process is to ensure that the systems are thoroughly tested. This testing should include unit testing of each computer program or module to ensure that programs are thoroughly tested and error free. In addition, systems should be tested with all programs and modules combined to ensure that the system performs as planned and designed.

Recommendation

The department should test revisions to batch process programs to ensure that these programs perform as designed.

Insufficient Control Over Access to Electronic Data Processing Programs and Data Files

Finding

The department's Electronic Data Processing (EDP) personnel have unrestricted access to programs and data files. For example, our testing identified three occasions where department EDP personnel accessed data files and used this information to run programs without following the department's authorization procedures. However, failure to restrict access to programs and data files could result in unauthorized changes to these programs and data files. Further, possible disclosure or misuse of confidential information contained in department data files could occur, although we did not find any examples of disclosure or misuse of confidential information. The Chief of the Division of EDP Service stated that the access controls system must be improved and that the new process will be in place no later than February 15, 1991.

Criteria

The California Government Code, Section 11771, requires agencies to maintain strict controls over EDP systems to prevent unauthorized access to programs and data files. In addition, the State Administrative Manual, Section 4841.3, states that automated files and data bases must be given appropriate protection from loss, inappropriate disclosure, and unauthorized modification.

Recommendation

The department should ensure that only authorized personnel are allowed access to the EDP systems, and only during the performance of authorized duties.

Inadequate Control Over Airline Travel

Finding

The department has insufficient control over the airline travel of its personnel. During our testing of airline invoices, we found that the department does not always ensure that its employees obtain supervisory approval prior to airline travel. In addition, between June 1987 and January 1990, the department received, from one company, $795,000 in airline travel invoices that the department did not reconcile with supporting documents.

Further, the department has not adequately separated the duties related to the request and authorization of airline travel and the subsequent payment of airline invoices. We noted eight instances, from July 1987 through February 1989, where an employee responsible for approving the payment of airline invoices also requested and authorized his own airline travel. Moreover, for three of the eight instances, the department could provide no evidence that this travel had been for the department's benefit. Further, in one instance, this employee purchased a round-trip airline ticket, then purchased an additional one-way ticket for travel on the same day as the previously purchased round-trip ticket. Subsequently, the department received and paid the invoice for both the round-trip and one-way tickets.

Finally, the department does not ensure that airline travel is incurred by only departmental employees. We identified an instance where airline travel was obtained by a departmental employee and used by an individual who was not a departmental employee.

Lack of control over airline travel has occurred because of the department's noncentralized system of purchasing airline tickets. The department allowed individual units to purchase airline tickets but did not make a specific unit responsible for oversight of these units' purchases of airline tickets.

Criteria

The State Administrative Manual, Section 8422.1 requires that agencies determine whether items listed on an invoice have been received before submitting a claim to the State Controller's Office for payment. Further, the State Administrative Manual, Section 8422.114, formerly Section 8422.115, which pertains to airline invoices, requires that the employee's copy of an airline ticket must be submitted with the employee's travel expense claim and that the copy of the airline ticket must be compared with the airline invoice to determine the propriety of the charge. Also, the State Administrative Manual, Section 8422.114, states that any unapproved charges must be collected from the employee. Finally, the California Government Code, Sections 13401(b)(1) and 13403, require agencies to have a satisfactory system of internal accounting and administrative control, including segregation of duties appropriate for the proper safeguarding of agency assets, and authorization and recordkeeping procedures that provide effective accounting control over expenditures.

Recommendation

The department should centralize the functions of airline travel procurement. In addition, the department should adequately separate the duties related to the request and authorization of airline travel and subsequent payment of the airline invoice. Also, prior to submitting claims to the State Controller's Office for payment, the department should reconcile all airline invoices with approved and properly supported travel claims to ensure that services have been received. Finally, the department should conduct an investigation to ensure that all instances of travel abuse have been identified.

Inadequate Support for Some Accounting Records

Finding

The department did not maintain adequate support for some amounts included in its financial statements. For example, the department was unable to provide documents necessary to support advances the department has made to the Office of the State Architect, as of June 30, 1990, for future building projects totaling $32.4 million. Specifically, the department could not identify the individual projects or provide the related documents to sufficiently support the $32.4 million. In another account, the department was unable to determine whether approximately $90,600 was owed to various counties or belonged to the department. This inability to identify the amount owed occurred because the reconciliation identifying the amounts the department had collected for the counties, and the amounts disbursed to the counties, had not been prepared since 1985.

Because the department did not reconcile all general ledger account balances with the related subsidiary ledgers monthly, the department was unaware that it was missing needed information. By performing a monthly reconciliation, the department can ensure that its financial statements are properly supported.

Criteria

The State Administrative Manual, Section 7800, requires subsidiary ledgers to be reconciled each month with the general ledger. Additionally, the State Administrative Manual, Section 7900, stresses the importance of reconciliations as an important internal control because they ensure that transactions have been correctly recorded and the financial statements are complete.

Recommendation

The department should reconcile subsidiary records with the general ledger monthly and maintain information necessary to support its financial statements.

Stephen P. Teale Data Center

We reviewed the financial operations and related internal controls at the Stephen P. Teale Data Center (data center).

Possible Liability to Federal Government

Finding

The State has a possible liability to the federal government of up to $4.5 million for the federal share of profits accumulated by the data center in its revolving fund from July 1, 1984, through June 30, 1990. In addition, the State may also owe the federal government for interest costs incurred by the data center in financing its equipment acquisitions. The unallowable interest charges totaled approximately $820,000 during fiscal years 1987-88, 1988-89, and 1989-90.

The data center's revolving fund is an internal service fund that provides data processing and related services to state agencies. The data center has charged these agencies more than its costs for providing services. In turn, state agencies have passed on a portion of the charges to federal programs. The revolving fund accumulates profits when its charges for services exceed its costs. Federal regulations prohibit the State from charging federal programs for more than its costs. Federal regulations also prohibit the State from charging interest costs to federal programs. In 1984, the federal Department of Health and Human Services (DHHS) audited the State's internal service funds' methods for setting rates. The audit covered the period July 1, 1969, to June 30, 1984. As a result of the audit, the State was required to refund to the federal government approximately $14.9 million in 1986. This amount was the federal share of profits accumulated by five of the State's internal service funds during the period covered by the audit. Of this amount, the State charged approximately $1.2 million to the data center's revolving fund.

Based on a Department of Finance analysis, the $1.2 million represented 14.8 percent of $8 million in accumulated profits of the data center at June 30, 1984. From July 1, 1984, to June 30, 1990, the data center's accumulated profits have increased by approximately $30 million, after audit adjustments. The State may be liable to repay the federal government some amount of the accumulated profits.

Using procedures similar to those of the Department of Finance and using the same ratio of 14.8 percent, we estimate that, under current federal regulations, the State may owe the federal government approximately $4.5 million. This amount is the federal share of profits accumulated by the data center during the period July 1, 1984, through June 30, 1990. However, proposed changes to federal regulations may reduce the State's liability to the federal government to approximately $3.1 million.

The data center also charged state agencies for interest costs for equipment acquisitions. Federal regulations prohibit the State from charging interest costs to federal programs. We used the same ratio of 14.8 percent to estimate charges to federal programs for unallowed interest costs for equipment acquisitions during fiscal years 1987-88, 1988-89, and 1989-90. We concluded that the State may have an additional liability to the federal government, under current regulations, of approximately $820,000 for the federal share of interest costs for equipment acquisitions incurred by the data center during these three fiscal years. For fiscal years 1984-85 through 1986-87, the data center did not separately disclose in its records interest costs for equipment acquisitions. Therefore, we did not calculate the State's potential liability to the federal government for the federal share of interest costs for those periods.

The data center advised us that it agrees that its retained earnings have grown by $30 million. However, according to data center officials, the federal share of state agencies' charges to federal programs in May 1986 was approximately 3.6 percent and is projected to be 1.84 percent in fiscal year 1990-91. According to the data center's estimate of federal participation at 3.6 percent, the data center may have a possible liability to the federal government of up to approximately $1.1 million and approximately $200,000 in unallowable interest. Because the federal government and the state executive branch are ultimately responsible for negotiating any final settlement, we did not attempt to compute the actual percentage of federal share of state agencies' charges to federal programs.

The possible liabilities to the federal government exist primarily because the data center's billing system is not designed to recover only the allowable cost that the data center incurs in providing services. Instead, it is also designed to provide the additional money needed to cover the cash flow of the data center, including additional investments in equipment.

We reported a similar finding during our financial audit for fiscal year 1988-89. We recommended that the Department of Finance develop guidelines that would insure that state agencies that receive services from the data center exclude amounts that exceed allowable costs when charging federal programs. In his response of March 16, 1990, the Director of Finance stated that he planned to address the issue of setting rates for internal service funds once the Office of Management and Budget decides on the amendments to Circular A-87, "Cost Principles for State and Local Governments."

Criteria

The California Government Code, Section 13070, provides the Department of Finance with general powers of supervision over all matters concerning the financial and business policies of the State. The California Government Code, Section 11754, allows the data center to accumulate profits in its revolving fund up to certain limits. However, the federal Office of Management and Budget, Circular A-87, "Cost Principles for State and Local Government," currently prohibits the State from charging federal programs for amounts that exceed costs. In addition, Circular A-87 prohibits states from charging federal programs for interest costs.

Proposed amendments to Circular A-87 would allow the State to retain a reasonable working capital reserve of up to 60 days' cash expenditures, excluding the costs for capital items. If this proposed amendment is approved and applied retroactively, the State's potential liability to the federal government for accumulated profits of the data center may be reduced. In addition, the proposed amendments would make interest cost on equipment acquisitions on or after January 1, 1989, an allowable cost.

Recommendation

The Stephen P. Teale Data Center and the Department of Finance should develop accounting procedures that ensure that the State complies with federal and state regulations. Compliance could be ensured by developing guidelines for the data center and for state agencies that receive services from the data center.

Inequitable Charges to State Agencies and Federal Government

Finding

The data center's charges to the Department of Motor Vehicles (DMV) for certain services that it provided to the DMV were not based on the data center's service rate schedule. As a result, the data center undercharged the DMV approximately $12 million over three years. In fiscal year 1989-90, the DMV paid the data center the contractual limit of $14.2 million; this amount was approximately $4.6 million less than the data center's costs based on its service rate schedule. For fiscal years 1988-89 and 1987-88, the data center charged the DMV less than its costs based on its service rate schedule by approximately $4.8 million and $2.6 million, respectively.

In our opinion, the data center's charges are inequitable because the data center charges state agencies, other than the DMV, based on its service rate schedule. Thus, a disproportionately large share of the data center's costs have been passed on to other state funds, including the State's General Fund, and to federal programs.

We reported a similar finding during our audit for fiscal year 1988-89. In its response in March 1990, the data center stated that it agreed to provide services to the DMV based on a fixed-fee agreement during a conversion period that is to be fully completed by the end of fiscal year 1990-91. The data center also stated that, upon completion of the conversion, the DMV will begin paying the same rates as all other clients of the data center. However, state policy requires state agencies to recover full costs whenever goods or services are provided for others. This policy, which applies to all agencies regardless of funding sources, is to be followed in all cases except where statutes prohibit full cost recovery. In addition, the State Administrative Manual, Section 4982.2, specifically requires the State's data centers to charge their users for units of service based on the center's published service rate schedule.

Criteria

The State Administrative Manual, Section 8752, specifies that State policy requires state agencies to recover full costs whenever the agencies provide goods or services for others. This policy, which applies to all state agencies regardless of funding sources, is to be followed in all cases except where statutes prohibit full recovery of costs. In addition, the State Administrative Manual, Section 4982.2, requires the State's data centers to charge their users for units of service based upon published service rate schedule.

Recommendation

The data center should consistently charge its users for services provided based on its published service rate schedule.

Weaknesses in Controls Over Equipment

Finding

The data center has weaknesses in its control over equipment. We noted the following conditions:

- The data center has not taken a complete physical inventory of its equipment within the last three fiscal years. During fiscal year 1987-88, the data center performed a physical inventory of equipment; however, this inventory count was for the Sacramento area only.

- The data center does not maintain a comprehensive inventory listing of equipment that it has retired from use and stored in its warehouse. As a result, we could not determine if the data center is properly accounting for equipment that it has retired from use. We reported a similar weakness during our financial audit for fiscal year 1988-89.

- The data center did not always identify and attach a tag with a state identification number to equipment that it purchased. State procedures require agencies to attach a tag with a state identification number to all state property as soon as practical after acquisition. In our audit of fiscal year 1989-90, we found that the data center did not attach tags with state identification numbers to 13 of the 15 equipment acquisitions that we tested. The data center often assigns a state identification number to new equipment but does not always attach the identification number tag to the equipment. We reported a similar weakness during our financial audit for fiscal years 1985-86, 1987-88, and 1988-89.

- The data center's equipment identification numbers listed in its accounting records did not always agree with the identification number assigned to the equipment. We found discrepancies for 3 of 15 items that we tested.

- The data center did not prepare property survey reports for 5 of the 12 equipment dispositions that we tested for fiscal year 1989-90. We reported a similar weakness during our financial audit for fiscal years 1987-88 and 1988-89.

The data center's failure to maintain sufficient accountability for its equipment prevents prompt detection of errors and exposes state property to increased risk of loss.

Criteria

The State Administrative Manual, Section 8652, requires agencies to make a physical count of all property at least once every three years and to reconcile the physical count with the accounting records. In addition, the State Administrative Manual, Section 8651, requires agencies to tag state property with a state identification number after acquisition when practical. Further, the State Administrative Manual, Section 8640, requires agencies to prepare property survey reports when agencies dispose of equipment and to submit these reports to the Division of Property Re-utilization at the Department of General Services for approval. Finally, the California Government Code, Sections 13401 and 13403, requires state agencies to maintain a system of internal controls to safeguard state assets.

Recommendation

The data center should comply with the requirements contained in the State Administrative Manual and the California Government Code to strengthen its controls over equipment.

Weaknesses in Accounting for Equipment

Finding

The data center has weaknesses in its accounting for equipment. Specifically, we noted the following conditions:

- The data center did not remove from its equipment balance at June 30, 1990, ten items of equipment that it sold or removed from service before the end of the fiscal year. The total value of the ten items was approximately $1.4 million. We reported a similar weakness during our financial audit for fiscal year 1988-89.

- The data center improperly recorded twice approximately $4,000 of installation costs of equipment.

- For 3 of the 15 equipment acquisitions that we tested for fiscal year 1989-90, the data center did not record all costs associated with the acquisitions. Specifically, it did not record approximately $14,000 in freight, sales tax, and other costs incurred in placing the equipment in operation. Instead, the data center recorded as expenses approximately $7,000 of sales tax and did not record approximately $7,000 in freight and installation costs because the vendor had not yet billed the data center.

- The data center improperly included in the equipment account approximately $317,000 in software costs. Software costs should be recorded in a separate asset account. We reported a similar weakness during our financial audit for fiscal year 1988-89.

- Because it did not identify the balance on its installment contract file as equipment purchases, the data center understated the balance in the equipment account and the contracts payable account at June 30, 1990, by approximately $855,000. We reported a similar weakness during our financial audit for fiscal year 1988-89.

The data center's failure to properly account for its equipment increases the risks of material misstatements in its fixed assets and depreciation expense records.

Criteria

The State Administrative Manual, Section 8631, requires agencies to record as part of the cost of acquired assets the costs of putting the assets in place and readying them for their intended use. In addition, the State Administrative Manual, Section 8621, requires agencies to remove disposed property from the accounting records. In addition, the California Government Code, Sections 13401 and 13403, requires agencies to maintain a system of internal controls that allows them to produce accurate and reliable financial data.

Recommendation

The data center should comply with the requirements contained in the State Administrative Manual and the California Government Code to improve its accounting over equipment.

Inconsistent Depreciation Policy

Finding

During fiscal year 1989-90, the data center did not have a consistent policy concerning the date on which depreciation should begin. For example, the data center may use the date the equipment is received, the date the first payment is made, or the date the data center put the equipment into service. The data center's purchasing agreements require that the equipment pass an acceptance test before the data center is obligated to buy the equipment. On November 30, 1990, the data center's accounting administrator said that he will use the date of acceptance in calculating depreciation of its equipment. However, until the data center uses the date of acceptance, its depreciation policy may cause the data center to improperly allocate the costs of the equipment over the equipment's estimated useful life. Improper allocation results in an inaccurate presentation of the data center's financial condition and results of operation.

Criteria

The State Administrative Manual, Section 8621, requires proprietary funds such as the Stephen P. Teale Revolving Fund to record depreciation. The State Administrative Manual, Section 8616, describes depreciation as allocating the cost of equipment over the time periods benefited. California Government Code, Section 13402, requires state agencies to establish and maintain a system of internal accounting and administrative controls. According to the California Government Code, Section 13403, a satisfactory system of internal accounting and administrative controls includes a system of recordkeeping procedures adequate to provide effective accounting controls over assets. In our opinion, the establishment of a consistent policy concerning the date on which depreciation should begin is an important recordkeeping procedure.

Recommendation

The data center should start depreciating its equipment using the date of acceptance.

Failure To Record Software Costs as Intangible Assets

Finding

The data center records the costs of the software it purchases as an operating expense rather than as an intangible asset. Intangible assets are assets that lack physical substance but give valuable rights to the owner. State regulations require state agencies to record certain software costs as intangible assets and to systematically allocate to expenses the cost of the software over its useful life. We identified two agencies that use a useful life of five years for software. Because the data center recorded its software purchases as expense, it overstated its operating expenses for fiscal year 1989-90 by approximately $1.3 million. In addition, the data center had not recorded intangible assets of approximately $4.5 million as of June 30, 1990.

We reported a similar weakness during our financial audit for fiscal year 1988-89.

Criteria

The State Administrative Manual, Section 8615.1, requires state agencies to record as intangible assets the costs of computer software that has an expected life of at least four years and costs at least $5,000. In addition, the State Administrative Manual, Section 8615, describes the cost of purchasing software as an intangible asset. Finally, the State Administrative Manual, Section 8621, requires proprietary funds such as the Stephen P. Teale Revolving Fund to record amortization. The State Administrative Manual, Section 8617, describes amortization as allocation of the cost of software, less its estimated residual value, to expense over the periods benefited.

Recommendation

The data center should record software costs as intangible assets and amortize those costs to expense over the periods that it expects to use the software to generate revenues.

Late Notification To Transfer Accountability of Funds

Finding

The data center was late in notifying the State Controller's Office of monies that it received, deposited, and identified as belonging to its revolving fund. The State Administrative Manual requires state agencies to notify the State Controller's Office of accumulated deposits of $25,000 or more by the Monday following the accumulation of such deposits. For fiscal year 1989-90, we noted that, for 21 deposits we reviewed totaling approximately $47 million, the data center did not notify the State Controller's Office on time.

When the data center does not promptly notify the State Controller's Office, monies belonging to the revolving fund are not available for the revolving fund's use. To earn interest income for the revolving fund, the State Treasurer's Office, on order of the State Controller's Office, invests monies of the revolving fund in excess of immediate needs in the Surplus Money Investment Fund. Because the data center was late in notifying the State Controller's Office to transfer the accountability for these monies, we estimate that the State's General Fund earned approximately $182,000 in interest income during fiscal year 1989-90 that the data center's revolving fund should have earned. We reported a similar weakness during our financial audit for fiscal year 1988-89.

Criteria

The State Administrative Manual, Section 8091, requires state agencies to notify the State Controller's Office of all monies determined to be revenue, reimbursements, abatements, and operating income by the first day of the week following the accumulation of $25,000 or more.

Recommendation

The data center should promptly notify the State Controller's Office of all monies identified as belonging to its revolving fund.

Weakness in Separating Accounting Duties

Finding

The data center does not have adequate separation of duties in its accounting section. Specifically, the person who authorizes disbursements also maintains the general ledger and prepares the bank reconciliations. Failure to adequately separate accounting duties can result in errors, irregularities, or illegal acts that may go undetected for extended periods.

Criteria

The State Administrative Manual, Section 8080, requires state agencies to separate functions so that the person who authorizes disbursements does not reconcile bank accounts and maintain the general ledger or any subsidiary ledgers affected by cash transactions.

Recommendation

The data center should separate its accounting duties to comply with the requirements in the State Administrative Manual.

Weakness in Control Over Salary Advances

Finding

The department does not promptly collect outstanding salary advances. In our analysis of 16 outstanding salary advances as of June 30, 1990, 15 advances totaling approximately $6,000 were outstanding for more than 30 days. Eleven of the 15 outstanding advances were over six months old.

Failure to collect advances from employees may result in the loss of state funds if the employees leave state service without repaying the advances. In addition, office revolving fund monies are not available for other uses when the advances are not promptly collected.

Criteria

The State Administrative Manual, Section 8118, requires agencies to collect a salary advance from the subsequently issued payroll warrant for the period covered by the salary advance.

Recommendation

The department should implement procedures to collect all outstanding salary advances.

Department of Transportation

We reviewed the financial operations and related internal controls of the Department of Transportation (department) and the department's administration of the U.S. Department of Transportation grant, Federal Catalog Number 20.205.

Federal Reimbursements Not Promptly Requested at Highest Rates Allowed

Finding

The department does not promptly adjust its reimbursement rates for federal aid projects to reflect the highest rates allowed by the federal government. The Federal Highway Administration (FHWA) approves the reimbursement rate for a project at the start of a project, and then, during the life of the project, the department may subsequently raise or lower the rate with FHWA approval. We noted that for two of the projects that we reviewed at the Fresno district office, the FHWA approved rate increases. However, the department did not revise its rates to reflect these increases until 15 and 22 months after approval, which resulted in an underbilling of costs to the federal government of approximately $12,000 during this period.

The department does not promptly revise its rates to reflect the highest rates allowed by the federal government because the department does not have a written policy directing staff to revise the rates.

Although it is the department's policy to recover the additional reimbursements after projects are completed through a final billing, the delay in promptly seeking reimbursement at the highest allowed rate results in a loss of potential interest earnings for the State. Moreover, since federal aid projects generally take several years to complete and normally an additional two years until final billing, the purchasing power of these funds is considerably less than if the department had promptly requested reimbursement at the highest rate allowed by the FHWA.

Criteria

The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from federal grant funds for goods and services provided. In addition, the FHWA Notice dated March 27, 1989, requires that the rates initially determined by the FHWA be retained throughout the life of the project, except that the State may choose to revise active projects by modifying agreements to use revised rates. Furthermore, sound fiscal policy dictates that the department requests reimbursement for project costs from the federal government as soon as possible to maximize the department's use of those funds.

Recommendation

The department should develop a written policy to ensure that staff promptly request reimbursements for federal aid projects at the highest reimbursement rate allowed by the federal government.

Service Center Rates Not Monitored and Adjusted

Finding

The department is not monitoring and adjusting the rates for its computer aided design and drafting (CADD) service center to ensure that the rates reflect the actual reimbursable costs of the center. In November 1985, the department received approval from the federal government to charge costs of the CADD service center to federal aid projects. However, the department has not monitored and adjusted its service center rates to reflect the actual reimbursable costs of the service center. Consequently, it may be overcharging or undercharging the federal government. As of June 30, 1990, the department has charged more than $10.5 million in CADD service center costs to federal aid projects.

Criteria

The Federal Aid Highway Program Manual, Volume 1, Chapter 4, requires the department to periodically review and, at least annually, adjust its rates for any overcharges or undercharges incurred in the preceding fiscal year.

Recommendation

The department should periodically review and, at least annually, adjust the rates for its CADD service center to ensure that the rates reflect the actual reimbursable costs of the service center.

Weaknesses in Separation of Duties

Finding

We noted the following instances where the department's district offices did not properly separate duties in their accounting departments.

- At the Fresno district office, the employee who receives and deposits remittances also keeps the cash receipts register and the cash disbursements register. In addition, the employee who operates the check-signing machine also compares checks with authorizations and supporting documents.

- At the San Luis Obispo district office, the employee who has authority to sign checks also has access to the blank check stock.

- At the San Francisco district office, the department's Audit and Internal Security (AIS) unit noted that the employee who prepares checks also compares checks with authorizations and supporting documents.

- At the Santa Ana district office, the department's AIS unit noted that the employee who operates the check-signing machine also compares checks with authorizations and supporting documents.

Without the proper separation of duties, an employee could conceal errors or irregularities, and management may be unable to determine who is responsible for the errors or irregularities.

Criteria

The State Administrative Manual, Section 8080, specifies that the employee who receives and deposits remittances should not keep both the cash receipts register and the cash disbursements register. In addition, this section specifies that the employee who prepares checks or operates the check-signing machine should not compare checks with authorizations and supporting documents. Furthermore, this section specifies that the individual signing checks should not have access to the blank check stock.

Recommendation

The department should ensure that the district offices assign duties among their employees in their accounting departments to provide proper separation of duties. If necessary, district offices should use employees from units other than the accounting department to provide proper separation of duties.

Expenditure Reports Not Submitted Promptly

Finding

The department's district offices did not submit either preliminary or final expenditure reports for completed construction projects to the department's headquarters by the required deadlines.

The Fresno district office identified 14 projects completed in fiscal year 1989-90 for which it submitted a preliminary or final expenditure report. For 13 of these 14 projects, the district office had not prepared preliminary or final expenditure reports within 120 days of completing the project as required by the Caltrans Accounting Manual. The reports ranged from 2 to 77 days late.

The San Luis Obispo district identified nine projects completed in fiscal year 1989-90. For 2 of the 9 projects, the district office had not prepared preliminary or final expenditure reports within 120 days of completion as required by the Caltrans Accounting Manual. The reports were 51 and 48 days late.

The department cannot submit final claims to the FHWA for project costs until the district offices submit the preliminary or final expenditure reports. Furthermore, until the FHWA reviews and approves a preliminary or final claim, the department cannot reallocate the unused portion of the authorized funds from the completed project for use on other projects.

We observed a similar weakness during our financial audit for fiscal year 1988-89. In March 1990, the department responded that it sent a letter to the districts in December 1989, emphasizing the need to comply with deadlines. In addition, the department responded that each month it sends a report to the districts indicating the expenditure reports that are outstanding.

Criteria

The Code of Federal Regulations, Title 23, Section 140.107, requires the department to promptly submit its request for reimbursement for a project after the project is completed. Additionally, the Caltrans Accounting Manual, Chapter 8, states that the district offices should submit the final expenditure report to the department's headquarters within 120 days of a project's completion.

Recommendation

The department's district offices should complete and submit either the preliminary or the final expenditure report within 120 days of a project's completion.

Late Deposit of Collections

Finding

The department's headquarters does not promptly deposit collections. Of the 10 cash receipts that we reviewed, the headquarters did not deposit 5 receipts, each of which exceed $50, within 5 working days, and it did not deposit 2 receipts for $6,901 and $15,974 within one working day as required by the State Administrative Manual. The 5 receipts were deposited on average 11 days after receipt while the other 2 receipts were deposited 4 and 8 days after receipt. In addition, at the Los Angeles district office, we noted 12 cash receipts from the district's machine shop that were deposited an average of 72 days after receipt. Failure to promptly deposit collections results in a loss of interest income to the State.

Criteria

The State Administrative Manual, Section 8030.1, stipulates that agencies deposit accumulated collections totaling $50 or more within 5 working days and must not hold any collections longer than 15 working days. This section also requires agencies to deposit collections of amounts more than $5,000 on the day that they are received unless they are received late in the day or another reason prevents their deposit.

Recommendation

The department should ensure that all collections are promptly deposited as required by the State Administrative Manual.

Noncompliance With State Requirements

Findings and Criteria

In the following instances, the department did not always comply with the administrative requirements of the State.

- For 3 of 11 checks we examined that were for more than $15,000 and payable to vendors outside the state system, the department did not require two signatures on the checks. The State Administrative Manual, Section 8041, requires two signatures on checks for more than $15,000 unless payable to another state agency or special dispensation is received.

- The department does not promptly cancel long-outstanding checks. As of June 30, 1990, the department listed 20 checks in its general cash account that have been outstanding longer than two years. Of the 20 checks, 15 have been outstanding for longer than three years, and 4 have been outstanding longer than four years. The State Administrative Manual, Section 8042, requires the department to cancel any general cash checks that have been outstanding for longer than two years and to remit the amount of the checks to the special deposit fund as unclaimed monies.

- For two federal aid projects that we reviewed at the San Luis Obispo district, the department used the wrong reimbursement rate to set up the projects in its federal billing system. As a result, the department underbilled the federal government for at least $29,600 in project costs for a period of 11 to 14 months. The California Government Code, Section 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Although individually these instances of noncompliance may not appear to be significant, they are deviations from the State's system of internal controls, which is designed to ensure that the public's resources are not vulnerable to abuse.

Recommendation

The department should improve its compliance with each of the state requirements.

Education

California Community Colleges, Chancellor's Office

We reviewed the financial operations and related internal controls of the California Community Colleges, Chancellor's Office (Chancellor's Office) and the Chancellor's Office's administration of the U.S. Department of Education grant, Federal Catalog Number 84.048 and the U.S. Department of Health and Human Services grant, Federal Catalog Number 93.025 (formerly Federal Catalog Number 13.786).

Overstatement of Liabilities

Finding

The Chancellor's Office overstated its due to other governments and expenditures accounts on its June 30, 1990, financial reports. Specifically, at least \$3.2 million of the \$21.7 million of encumbrances that the Chancellor's Office reported on its general fund financial reports for fiscal year 1989-90 were not supported by valid contracts. According to generally accepted accounting principles, an encumbrance represents a commitment related to unperformed contracts for goods and services.

At year-end, the accounting office accrued amounts, based on information from the program units, that the Chancellor's Office was planning to use but for which fully executed contracts were not yet available. During our audit, we noted that the Chancellor's Office did not complete the contracting process by the time of our testing. We found the following specific examples:

- In our testing of encumbrances, we identified six items totaling approximately \$2.6 million that were not supported by fully executed contracts. The Department of General Services approved one of the contracts, totaling \$1 million, on November 5, 1990, but none of the remaining five contracts were finalized by December 31, 1990.

- On its list of encumbrances, the Chancellor's Office included seven items totaling approximately \$568,000 that had been originally encumbered at June 30, 1989. Although the

Chancellor's Office had assigned contract numbers and identified vendors for each of these items, the contracts were never finalized in the 16 months between June 30, 1989, and October 26, 1990. On October 26, 1990, the Chancellor's Office deleted these items from its accounting records.

Criteria

The State Administrative Manual, Section 10544, requires state agencies to review their records at June 30 to ensure that they have accurately analyzed and recorded all amounts owed to others. In addition, this section requires agencies to delete encumbrances from their records that are not valid obligations of the year just ended and, if appropriate, reestablish the amounts in the accounts of the new fiscal year.

Recommendation

The Chancellor's Office should not encumber its general fund by amounts for which it does not have valid contracts.

Incorrect Financial Statements

Finding

The Chancellor's Office did not properly prepare its fiscal year 1989-90 financial reports for either its general fund or its 1988 Higher Education Capital Outlay Bond Fund. During our audit, we noted the following conditions:

- The Chancellor's Office incorrectly reported its prior year accruals when it prepared its general fund financial reports for fiscal year 1989-90 because it could not resolve differences between its records and those of the State Controller's Office. As a result of this incorrect reporting, the Chancellor's Office understated its expenditures by approximately $16 million. The Chancellor's Office experienced a similar problem in preparing its financial reports for fiscal year 1988-89, as the State Controller's Office noted in a May 1990 letter to the Chancellor's Office.

- The Chancellor's Office incorrectly reported only the total amount of its encumbrances on its general fund report of accruals. When the State Controller's Office requested a detailed list of encumbrances by liability account, the Chancellor's Office reported amounts that were not supported by its accounting records.

- The Chancellor's Office submitted an incomplete statement of contingent liabilities to the State Controller's Office. Specifically, the Chancellor's Office did not disclose a general fund liability to the federal Department of Education of approximately $965,000 that existed at June 30, 1990.

- The Chancellor's Office understated its general fund trial balance footnote on future commitments by approximately $13 million. The amount omitted represents the remaining balances on its deferred maintenance contracts for fiscal year 1989-90. Although the automated accounting system used by the Chancellor's Office included these balances on an error listing, the Chancellor's Office did not resolve the error listing items before it submitted its financial reports.

- The Chancellor's Office overstated four accounts on its balance sheet for the 1988 Higher Education Capital Outlay Bond Fund because it posted amounts to the wrong general ledger accounts. It did not identify this error because it did not reconcile its records with those of the State Controller's Office and the State Treasurer's Office. Specifically, the Chancellor's Office incorrectly used the liabilities for deposits account to report approximately $56 million that was actually a reduction in its cash account. In addition, the Chancellor's Office overstated its deposits in the Surplus Money Investment Fund by approximately $70 million, its Pooled Money Investment Account loan payable by $13 million, and its fund balance by $1 million.

Failure to submit prompt and accurate financial reports delays the compilation by the State Controller's Office of the State's financial statements.

Criteria

The State Administrative Manual, Sections 7900 through 7979, describes how state agencies should prepare their annual financial reports, including footnotes and accruals. In addition, the State Controller's Office issued a memorandum dated May 15, 1990, that provides state agencies with detailed instructions for preparing their financial reports. This memo also informs agencies that the State Controller's Office will provide them with prior year accrual numbers and that these numbers are not to be changed. The State Administrative Manual, Section 7952, describes how agencies should report encumbrances on the report of accruals and provides an illustrated example of a properly prepared report.

The State Administrative Manual, Section 7979, requires that the statement of contingent liabilities include disclosures of federal audit exceptions. Additionally, the California State Accounting and Reporting System (CALSTARS) Procedures Manual, Volume 2, Chapter II, requires that all accounting transaction errors be corrected as soon as possible. Finally, the CALSTARS Procedures Manual, Procedure P-14, provides specific procedures and accounts to be used to account for bond funds with Pooled Money Investment Account loans.

Recommendation

The Chancellor's Office should prepare correct financial reports in accordance with the State Administrative Manual. In addition, it should implement procedures to eliminate the types of errors that it made on its financial reports for fiscal year 1989-90. The Chancellor's Office should also ensure that it discloses all contingent liabilities, including federal audit exceptions. Moreover, it should review and resolve all errors on error listings generated by its automated accounting system before completing its financial reports. Finally, the Chancellor's Office should ensure that it follows all appropriate accounting procedures when posting its accounting records, and it should reconcile its records with the records of the State Controller's Office, and the State Treasurer's Office.

Insufficient Control Over Apportionment Payments

Finding

During fiscal year 1989-90, the Chancellor's Office did not ensure that the State Controller's Office made the correct apportionment payments to the community college districts. The Chancellor's Office and the State Controller's Office share the responsibility for accounting for State School Fund expenditures. The Chancellor's Office is responsible for calculating community college apportionments and then authorizing the State Controller's Office to make the appropriate payments from the State School Fund. During our audit, we noted the following conditions:

- The Chancellor's Office did not provide the State Controller's Office with sufficient information to properly pay the community college districts. Although the Chancellor's Office authorized the apportionment payments in total for each community college district, it did not provide the State Controller's Office with a schedule specifying how much the community college districts were owed for the various programs within the apportionment. The State Controller's Office made certain assumptions and recalculated the payments by program. As a result, the State Controller's Office made payments of approximately $2.6 million from the incorrect program and incorrectly posted a prior year correction of approximately $6,000.

- The Chancellor's Office did not compare the detail of the apportionment payments made by the State Controller's Office with the amounts that the Chancellor's Office had calculated for each community college district by program. Although the Chancellor's Office reconciled its apportionment calculations with the State Controller's Office's records in total, it did not reconcile its calculations with the State Controller's Office's records by program. As a result, the Chancellor's Office did not know that the errors discussed above were not corrected as of June 30, 1990.

During our audit, we observed that for fiscal year 1990-91, the Chancellor's Office began reconciling its records with the State Controller's Office's records by program, as well as in total. The Chancellor's Office is also providing the State Controller's Office with a payment schedule by program and is establishing a system with the State Controller's Office to resolve questions and discrepancies.

Criteria

The Budget Act of 1989, (Chapter 93, Statutes of 1989) Item 6870-101-001, Provisions 1 through 20, specifies how much each program has available for apportionment. In addition, the State Administrative Manual, Section 7900, discusses the importance of making regular reconciliations. Reconciliations represent an important element of internal control by providing confidence that transactions have been adequately processed and that the financial records are complete.

Recommendation

The Chancellor's Office should continue to reconcile its apportionment calculations with the records of the State Controller's Office by program to ensure that apportionment payments are made in accordance with its instructions. Further, the Chancellor's Office should work with the State Controller's Office to ensure that the two agencies are aware of and make all necessary apportionment payments and adjustments.

Payment Made Without Proper Approval

Finding

The Chancellor's Office did not obtain the necessary approval before paying a community college district for expenditures from years for which appropriations are no longer available. Specifically, the Chancellor's Office used approximately $257,000 in funds from the fiscal year 1988-89 Disabled Students Programs and Services (DSP&S) program at the Yosemite Community College District to pay the Peralta Community College District for expenditures that the Peralta district had made in prior fiscal years, including approximately $166,000 that it spent in fiscal years 1983-84 and 1984-85. However, the Chancellor's Office did not first obtain the required approval from the Board of Control to use currently available funds to pay for expenditures from years for which appropriations are no longer available. During our audit, we determined that the Chancellor's Office paid the Peralta district on June 15, 1990, although it did not submit the claim to the Board of Control until September 19, 1990, three months later.

In addition, the Chancellor's Office did not keep sufficient documentation to fully support how it calculated portions of the payment. The Chancellor's Office also failed to document the Peralta district's explanation of the adverse fiscal impact it would experience if it were not paid for the costs incurred.

Criteria

The California Government Code, Section 16304, specifies that an appropriation may be encumbered for three years after the date that it first becomes available, unless otherwise limited by law. Further, the Government Code, Section 16304.1, states that, after a budget appropriation becomes unavailable, any unpaid obligation against that appropriation may be paid, with approval of the Board of Control, from any current appropriation available for the same purpose. Finally, the Government Code, Sections 13402 and 13403, requires that agencies ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over expenditures.

Recommendation

The Chancellor's Office should follow the Government Code and obtain Board of Control approval before making payments from currently available funds for expenditures from years for which appropriations are no longer available.

Lack of Control Over Travel Expenses

Finding

The Chancellor's Office lacks controls over its travel expenses. For 3 of the 59 claims transactions we tested, the Chancellor's Office paid travel costs without evidence of proper approvals. Specifically, the Chancellor's Office has not clearly identified those employees authorized to approve travel documents; it does not have procedures to ensure that it pays for airline tickets or rental cars only for employees who are authorized to travel; and it does not have procedures to verify that it pays for only those airline tickets actually used.

In addition, the Chancellor's Office has improperly allowed employees traveling on state business to instruct hotels to bill the Chancellor's Office for expenses incurred. Because the employees did not submit travel expense claims in these cases, the Chancellor's Office did not have the necessary information, such as departure and arrival times, to verify the propriety of the charges. Although the Chancellor's Office deducted approximately $130 representing excess meal costs, excess room rates, long-distance telephone calls, and movie rentals from two hotel invoices totaling $1,132 that we reviewed, the Chancellor's Office may have paid other improper travel costs.

Criteria

The State Administrative Manual, Section 8422.1, requires agencies to determine that invoiced items, including items covered by travel vouchers, were received and that authority existed to obtain the items. In addition, the State Administrative Manual, Sections 8422.114 and 8422.115, requires employees to submit their copies of airline tickets and automobile rental contracts with their travel claims so that the agency can compare these copies to the respective invoices to determine the propriety of the expenditure. Further, the California Code of Regulations, Title 2, Section 599.619, states that employees on travel status shall be reimbursed for lodging, meals, and incidental expenses. The California Code of Regulations, Title 2, Sections 599.638(a) and 599.638(c), states that no state agency will pay a travel expense account unless it is submitted on a travel expense claim; each officer and employee making a claim for travel expenses must show the inclusive dates of each trip for which allowances are claimed and the times of departure and return.

Recommendation

The Chancellor's Office should establish a list of employees authorized to sign travel documents. In addition, the Chancellor's Office should require all employees to submit travel expense claims before they are reimbursed for travel expenses.

Lack of Control Over Disbursements

Finding

The Chancellor's Office lacks controls over its disbursements. During our audit, we noted the following deficiencies:

- The Chancellor's Office has no procedure for reviewing calls charged to its telephones. In our review of three invoices for telephone service, we noted that the telephone activity included many calls to various parts of the state and some calls to other states. Since the Chancellor's Office must regularly communicate with community colleges and districts throughout the State and with out-of-state organizations, it needs to review its monthly telephone bills to ensure that it pays only for business-related calls. A person with daily knowledge of the employees' work could most accurately judge whether the calls were proper, so unit supervisors should be given the responsibility to review the portion of the telephone bill that relates to their unit.

- Purchase documents do not always contain evidence that the Chancellor's Office has verified the receipt of billed goods or services. In our review of 15 cash disbursements, we found one transaction for $4,791 that lacked evidence that the Chancellor's Office had received the billed goods or services before paying for them. We reported a similar weakness in our financial audits of the last three fiscal years.

Criteria

The State Administrative Manual, Section 4525.8, states that the agencies should establish a review process of all toll calls. In addition, the State Administrative Manual, Section 8422.20, states that an agency will prepare stock-received reports at the time goods are received and that the reports will be prepared only after carefully verifying the quantity, description, and condition of the goods.

Recommendation

The Chancellor's Office should implement procedures to review toll calls charged to its telephones. In addition, the Chancellor's Office should ensure that it verifies the receipt of goods and services before paying for them.

Late Remittances to the State Treasurer's Office

Finding

The Chancellor's Office did not promptly remit money to the State Treasurer's Office. We tested $6.5 million (82 percent) of the total $7.9 million that the Chancellor's Office remitted to the State Treasurer's Office during fiscal year 1989-90. Of this amount, the Chancellor's Office remitted approximately $5.5 million from 2 to 15 days later than required by the State Administrative Manual. When the Chancellor's Office does not remit the money promptly to the State Treasurer's Office, this money will not be recorded to the proper fund and, therefore, will not be available for its intended purpose. We reported a similar weakness in our financial audits of fiscal years 1986-87 and 1987-88.

Criteria

The State Administrative Manual, Section 8091, requires that, when an agency accumulates deposits of $25,000 or more, the agency must remit the money to the State Treasurer's Office no later than the first day of the week following the accumulation of that amount.

Recommendation

The Chancellor's Office should promptly remit amounts to the State Treasurer's Office in accordance with the State Administrative Manual.

Weaknesses in Control Over the Revolving Fund

Finding

The Chancellor's Office does not properly maintain its listing of expense, travel, and salary advances made from the revolving fund. During our review of the June 30, 1990, listing, we noted that several items totaling $15,243 had been outstanding for more than one year. Because of insufficient documentation, we were unable to verify whether the Chancellor's Office could collect the long-outstanding advances.

We reported a similar weakness in fiscal year 1988-89. At that time, the accounting administrator acknowledged that the listing of advances made from the revolving fund was not accurate. According to the administrator, several errors made during the past years have never been researched, and many of the errors cannot be resolved because of a lack of support documentation. Although the Chancellor's Office responded that it would file a Board of Control claim for the uncollectible amount during fiscal year 1988-89, as of February 7, 1991, it had filed no such claim.

Criteria

The State Administrative Manual, Sections 8190 and 8192, requires state agencies to maintain a listing of advances made from the revolving fund to account for all the fund's transactions. In addition, the State Administrative Manual, Section 8116, requires agencies to reimburse and, therefore, clear advances from the records when employees submit their travel expense claims. This section also requires that agencies keep records in sufficient detail to ensure compliance with travel advance requirements. Finally, the State Administrative Manual, Section 8118, states that agencies must collect salary advance repayments from the subsequently issued payroll warrants for the time periods covered by the salary advances.

Recommendation

The Chancellor's Office should properly maintain the listing of advances made from the revolving fund and implement procedures to collect all long-outstanding advances or file a claim for uncollectible amounts.

Accounting Transactions Insufficiently Documented

Finding

The Chancellor's Office was unable to identify or document and, therefore, could not resolve five reconciling items, totaling approximately $53,000, that were included on the March 31, 1990, reconciliation of its general checking account. Two of these items were outstanding for over four years, and the remaining three items were outstanding for over two years. The largest unidentified reconciling item, approximately $34,000, is a receipt for which no cash appears to exist. Further, the Chancellor's Office had in its reconciliation four additional reconciling items, totaling approximately $20,000, that were outstanding for at least three years. Two of these items were outstanding for over four years.

We reported a similar weakness in our financial audits for fiscal years 1985-86, 1986-87, 1987-88, and 1988-89. The Chancellor's Office concurred with the weakness and stated that it would implement procedures to correct the weakness. However, as of March 31, 1990, the Chancellor's Office had not corrected the weakness. Failure to clear these reconciling items may result in the Chancellor's Office not promptly detecting errors or irregularities such as unauthorized cash disbursements or failure to deposit money.

Criteria

The State Administrative Manual, Section 7967, requires that an explanation of the nature of every reconciling item be made a part of the monthly bank reconciliation. It also requires that the person reconciling the bank statement trace every unusual reconciling item to identify its nature.

Recommendation

The Chancellor's Office should identify and support all accounting transactions it makes in its accounting records. Further, it should resolve all reconciling items in its general checking account.

Weak Internal Controls Over Property

Finding

As we have reported for the last seven years, the Chancellor's Office has not reconciled its physical inventory of property with its accounting records for the last eight years. In addition, the Chancellor's Office has not completed a physical inventory of all property within the last four years. Without accurate property records, the Chancellor's Office cannot reconcile the property records with the accounting records. Failure to complete physical inventory counts and to reconcile the physical inventory counts with the accounting records can result in the failure to detect the loss or theft of state property. In response to our fiscal year 1988-89 report, the Chancellor's Office stated that it would begin a property inventory; it began this inventory in September 1990.

Criteria

The State Administrative Manual, Section 8652, requires that agencies make a physical count of all property and reconcile the count with accounting records at least once every three years.

Recommendation

The Chancellor's Office should complete a physical count of all property and reconcile the count with the accounting records.

Inadequate Controls Over Contracts

Finding

The Chancellor's Office does not maintain adequate controls over its contracts. We found the following specific deficiencies:

- For two of the ten contracts we reviewed, we found that the contractors began contract work before the Department of General Services had approved the contracts. If the Department of General Services had not approved these contracts, the State might still have been liable for the work performed and might have incurred litigation costs regarding the State's obligation to pay for that work.

- Five contracts in our test required a review of contractor evaluations, yet the Chancellor's Office did not review these evaluations before awarding the consulting contracts. When the Chancellor's Office does not know about the State's previous experience with a particular consultant contractor, it may not be contracting in the State's best interest.

Criteria

At the time of our testing, the Public Contract Code, Section 10371(e), required that no consulting services contractor be awarded a contract unless the department had reviewed a contractor evaluation form on file with the Department of General Services. If the contractor did not have a previous contract with any state entity, a completed resume for each contract participant who was to exercise a major administrative role or major policy or consultant role was to be attached to the contract for public record. The State Administrative Manual, Section 1209, requires departments to submit each contract in time for the Department of General Services to approve the contract before work commences.

Recommendation

The Chancellor's Office should follow contract policies and procedures as set forth in the Public Contract Code and the State Administrative Manual to ensure that contracts are properly awarded and completed in the State's best interest.

More Improvement Needed Over Cash Management

Finding

Although the Chancellor's Office has taken steps to improve its system for managing its federal vocational education funds, it still needs to improve. The Chancellor's Office acts as an intermediary in the allocation of these funds between the California Department of Education (CDE) and subrecipient organizations, including community college districts. Each fiscal year, the Chancellor's Office contracts with the CDE for the Chancellor's Office's share of the federal vocational education funds. It requests cash advances of its federal vocational education funds from the CDE and then disburses the funds to the subrecipients. During fiscal year 1989-90, the Chancellor's Office had three active vocational education contracts.

In our audits of the last three fiscal years, we reported that the Chancellor's Office requested funds in excess of its and the subrecipients' needs. In fiscal year 1989-90, the Chancellor's Office changed its cash management procedures and did not request any reimbursements from the CDE until it had reconciled its accounting records with its vocational education program records and determined its actual needs. However, for the fiscal year 1987-88 and 1988-89 contracts, the Chancellor's Office took ten months to determine its actual needs and did not promptly request reimbursement from the CDE for approximately $1.4 million for expenditures under these contracts. As a result, the State lost potential interest earnings of approximately $38,000. The Chancellor's Office promptly requested reimbursements under its fiscal year 1989-90 contract.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), requires that cash advances be limited to the minimum amounts needed and timed to be in accord with the actual and immediate cash requirements of the funded programs. This section also stipulates that the timing and amount of cash advances be as close as administratively feasible to the actual disbursement by the recipient organization. In addition, the State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from grant funds for goods and services provided.

Recommendation

The Chancellor's Office should continue its efforts to control its system for managing its federal vocational education funds to ensure that it promptly requests reimbursements of federal funds.

Noncompliance With Federal and State Requirements

Findings and Criteria

In the following instances, the Chancellor's Office did not comply with administrative requirements of the federal government and the State:

- For one of the 12 vocational education allocations that we tested, the Chancellor's Office used incorrect enrollment data for one community college district when calculating the funding for the handicapped, limited English proficiency, sex bias, and Title II, Part B programs. As a result, the district received approximately $19,000 less than the amount to which it was entitled. The Code of Federal Regulations, Title 34, Sections 401.95(b) and 401.96(a)(2), requires that the State allocate 50 percent of the amounts reserved for the allocations for handicapped students, disadvantaged students, and students with limited English proficiency on the basis of the relative number of such students served during the preceding program year.

- The Chancellor's Office overcharged the federal government for its share of the salary costs of the vocational education program because its automated accounting system was set to allocate approximately 84 percent of one employee's salary to the federal government instead of the required 75 percent. As a result, for fiscal years 1988-89 and 1989-90, the Chancellor's Office overcharged the federal government by at least $9,300. The Chancellor's Office corrected the fiscal year 1989-90 billing before June 30, 1990. However, as of October 1, 1990, the Chancellor's Office had not adjusted its fiscal year 1988-89 billings or investigated earlier fiscal years for similar problems. Because the error was in the automated accounting system's master table, the federal government may have been overcharged in prior years. The federal Office of Management and Budgets, Circular A-87, states that the allocation of joint costs must be supported by formal accounting records that will substantiate the propriety of eventual charges.

- The Chancellor's Office submitted its final financial status report for its fiscal year 1987-88 vocational education program on June 1, 1990, five months after the due date of December 31, 1989. In addition, it did not sufficiently document the date it submitted its annual performance report. The Code of Federal Regulations, Title 34, Section 74.73(d), states that final status reports are due 90 days after the expiration or termination of grant support. The Code of Federal Regulations, Title 34, Section 74.82(b), states that the annual performance report is due 90 days after the end of the grant year. We reported a similar weakness in our audits for fiscal years 1987-88 and 1988-89.

- At June 30, 1990, the Chancellor's Office reported approximately $402,000 of cash on hand on its balance sheet for the Community College Credentials Fund. Because the Chancellor's Office did not deposit this cash until the period July 2, 1990, through August 15, 1990, the State lost potential interest earnings of approximately $2,700. The State Administrative Manual, Section 8030.1, requires state agencies to deposit accumulated collections totaling $50 or more within five working days of receipt and to deposit all collections within 15 working days of receipt.

- The Chancellor's Office does not maintain inventory records of the publications that it sells. The State Administrative Manual, Section 8785, requires agencies to maintain quantity stock cards by title for all publications that it sells.

Although individually these instances of noncompliance may appear insignificant, any noncompliance with federal regulations or deviation from the State's system of internal controls makes the public's resources vulnerable to abuse.

Recommendation

The Chancellor's Office should improve its compliance with each of the federal and state requirements.

California State University

We reviewed the financial operations and related internal controls at the California State University (CSU).

Weak Controls Over Purchasing

Finding

CSU Dominguez Hills and CSU Sacramento did not always provide adequate control over purchasing. For example, to avoid obtaining the Department of General Services' approval of purchase orders for $100,000 and over, CSU Dominguez Hills split a $250,000 purchase order for library books into three orders of $100,000, $100,000 and $50,000. In addition, CSU Sacramento paid for certain services without valid contracts. Specifically, CSU Sacramento hired and paid writing proficiency examination proctors as independent contractors without executing contracts. Failure to follow required purchasing procedures may result in the State not maximizing funds used for purchases.

Criteria

The Public Contract Code, Section 10295, provides that expenditures of $100,000 or more be approved by the Department of General Services. In addition, good business practices require state agencies to enter into agreements, such as purchase orders and contracts, before purchasing goods or services.

Recommendation

CSU Dominguez Hills and CSU Sacramento should follow the state requirements and good business practices for procuring goods and services.

Inaccurate Analysis and Reporting of the Encumbrances Classification

Finding

CSU Dominguez Hills, CSU Los Angeles, and CSU Sacramento did not accurately analyze and report encumbrances at June 30, 1990. Under generally accepted accounting principles, encumbrances are that portion of accounts payable that represent goods or services received or provided after June 30. For their portion of the State's General Fund, CSU Los Angeles understated encumbrances on the Report of Accruals to Controller's Accounts by $379,000; CSU Sacramento understated its encumbrances by $325,000. In contrast, CSU Dominguez Hills overstated its encumbrances by $106,000. These misstatements occurred because CSU Dominguez Hills, CSU Los Angeles, and CSU Sacramento did not accurately analyze their commitments to determine whether they had received the goods or services before or after June 30.

Failure to analyze and report payables and encumbrances accurately to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately and in accordance with generally accepted accounting principles.

We reported similar weaknesses at other campuses for fiscal year 1987-88 and 1988-89.

Criteria

The State Administrative Manual, Section 10544, requires agencies to analyze their obligations and encumbrances at June 30 and to determine whether they received the goods and services before or after June 30.

Recommendation

CSU Dominguez Hills, CSU Los Angeles and CSU Sacramento should accurately analyze their commitments to determine whether they received the goods or services before or after June 30 and appropriately report the commitments as payables or encumbrances.

Weak Controls for Revolving Fund

Finding

CSU Dominguez Hills and CSU Los Angeles did not properly control the activities of their office revolving funds. As of March 31, 1990, CSU Dominguez Hills listed travel advances from its revolving fund totaling $6,895 and salary advances of $6,807. These advances had been outstanding for more than 120 days. Moreover, $4,818 in the salary advances had been outstanding for more than 27 months. In addition, CSU Dominguez Hills does not maintain a list of vendors paid from the revolving fund. As a result, reimbursements to the revolving fund are not prompt.

CSU Los Angeles did not prepare its year-end "Analysis and Reconciliation of Revolving Fund Accountability Report" according to the provisions in the State Administrative Manual. Specifically, the reconciliation did not provide an accurate detail list of travel advances that was equal to the travel advances reported on the year-end trial balance. Nevertheless, the listing indicated that at least $20,321 of travel advances and $27,556 of salary advances had been outstanding for at least 90 days.

Weak controls over revolving fund activities may result in undetected errors and irregularities and unnecessarily reduce funds available for other uses. Further, failure to establish procedures to collect advances due from employees may result in the loss of state funds if employees leave state service without repaying the advance.

Criteria

The State Administrative Manual, Section 8116, provides that travel advances to employees are for temporary purposes, and Section 8118 provides that salary advances are for time worked. These sections require an agency to reimburse and, therefore, clear travel when travel is completed and salary advances when the payroll warrants are issued. In our opinion, these time frames are not intended to extend up to and over 90 and 120 days from when travel is completed and the payroll warrants are issued.

The State Administrative Manual, Sections 8190 and 8192 require state agencies to maintain listings of advances made from the revolving fund to account for all the fund's transactions. Section 7964 requires that state agencies reconcile their revolving fund each month. The reconciliation procedures require that the balance of the revolving fund cash plus all of the receivables (advances) equal the amount of the revolving fund.

Recommendation

CSU Dominguez Hills and CSU Los Angeles should collect all long-outstanding advances as required by the State Administrative Manual. In addition, CSU Dominguez Hills and CSU Los Angeles should follow the requirements of the State Administrative Manual to prepare complete reconciliations of their revolving funds each month.

Weak Internal Controls Over Expenditures

Finding

CSU Dominguez Hills, CSU Los Angeles, and CSU Sacramento have weak controls over expenditures. In our review of 31 expenditures at CSU Dominguez Hills, we found that the university made one expenditure without evidence that the goods were received and one expenditure that had not been approved for payment by the authorizing individual. In our review of 29 travel expense payments at CSU Los Angeles, we found 4 improper travel expense payments. Two of the payments exceeded the allowable per diem rates by $145.00. In another instance, $53.00 in meal expenses were improperly paid for nonuniversity employees. Finally, we found a questionable payment of $154.00 for phone usage that had not been identified as business related. At CSU Sacramento, we found that $40,000 was paid on August 30, 1990, for data processing services that were not received at that time. These services still had not been received at the time of our review in October 1990.

CSU Dominguez Hills made a $250,000 advance payment for the delivery of an unspecified quantity of library books at an unspecified date. The agreement between the vendor and the university regarding this advance payment provided for an 18 percent discount of $45,000. CSU Dominguez Hills did not take advantage of this discount at the time of the advance payment. The director of accounting services stated that the discount will be deducted from invoice prices of books delivered in the future and confirmed to us that the agreement is protected by a performance bond for the period June 1, 1990 to May 31, 1991.

Payments for items that are not allowed by state regulations, failure to take allowed discounts,and payments for goods or services without evidence of authorization or receipt of the goods or services, can result in the loss of state funds.

Criteria

The State Administrative Manual, Section 8422.1, requires evidence that goods were received and that cash discounts have been taken before state agencies submit claims to the State Controller's Office for payment. In addition, the California Code of Regulations, Title 2, Section 701 (c)(1) provides that an employee on travel status be reimbursed on an allowable per diem basis for personal expenses incurred. Further, Section 701 (c)(2) provides that business expenses consist of phone calls necessary to complete official business.

Recommendation

CSU Dominguez Hills, CSU Los Angeles, and CSU Sacramento should provide adequate controls over state expenditures to comply with the State Administrative Manual and the California Code of Regulations.

Noncompliance With State Requirements

Findings and Criteria

We noted the following instances where the campuses did not always comply with administrative requirements of the State.

- CSU Dominguez Hills and CSU Los Angeles each did not obtain the required two signatures on a check that was greater than $15,000 and payable to vendors outside of the state system. The State Administrative Manual, Section 8001.2, requires two signatures on checks over $15,000 unless the checks are payable to the State Treasurer's Office or another state agency or unless special dispensation is received.

- At CSU Los Angeles, the general cash account balance was overdrawn by $326,996 at June 30, 1990. The State Administrative Manual, Section 8047, requires that agencies make every effort to prevent overdrafts in their general cash accounts.

- CSU Sacramento does not always deposit cash receipts promptly. Twenty-four of 30 deposits of $5,000 or more that we reviewed were deposited more than one working day after receipt. The State Administrative Manual, Section 8030.1, provides that receipts of $5,000 or greater be deposited no later than the next working day after receipt. During fiscal year 1989-90, the State lost approximately $13,000 in interest it could have earned if these receipts had been deposited promptly.

These issues individually may not appear significant, but they are deviations from the State's system of internal controls, which are designed to ensure that the public resources are not vulnerable to abuse.

California Student Aid Commission

We reviewed the California Student Aid Commission's (commission) administration of the U.S. Department of Education grant, Federal Catalog Number 84.032.

Failure To Ensure Adequate Collection Efforts on Defaulted Loans

Finding

The commission did not always ensure the adequacy of efforts to collect on defaulted student loans purchased by the commission. The commission is required to follow specified procedures when attempting to collect defaulted student loans that it has purchased. The commission's service contractor and various collection agencies perform these procedures. For 19 of 44 loans that we reviewed, the commission's service contractor or the assigned collection agency did not perform at least one of the required procedures.

For 11 of the 19 loans that we identified as having insufficient collection procedures, the commission's service contractor did not either telephone or send any collection letters during the first 45 days of the collection period as required by federal regulations. The borrowers of 7 of these 11 loans also had loans on which they had previously defaulted. The manager of the commission's Preclaim, Claim, and Bankruptcy Division stated that the commission interpreted the requirement to allow it to combine the balances of newly defaulted loans for one borrower with previously defaulted loans of that borrower. The commission believed it could then continue collection activities according to the cycle of the first defaulted loan. However, we do not believe that the federal regulations specifically allow such an interpretation.

For the remaining 8 loans, the commission's service contractor or the service agency either did not make all required telephone attempts, did not send all required letters, or did not perform all required procedures for locating borrowers in subsequent collection periods.

Because the commission did not ensure that required collection procedures were followed, it could be losing payments on defaulted loans. In addition, failure to follow federal requirements for collections could jeopardize federal reimbursements and could result in the federal government taking action against the commission's administration of the federal Higher Education Act Insured Loans program. We observed a similar weakness in our audit for fiscal year 1988-89.

Criteria

The Code of Federal Regulations, Title 34, Section 682.410(b)(4), requires the commission to engage in diligent collection efforts including a specified number of telephone calls and letters in each predetermined collection period after the commission pays a default claim on a loan.

Recommendation

The commission should ensure that the required collection efforts are made on all defaulted student loans.

Failure To Ensure That Defaulted Student Loans Met Federal Reimbursement Requirements

Finding

The commission did not ensure that all of the defaulted student loans that it submitted for reimbursement to the federal government met federal requirements for reimbursement. Before the commission purchases defaulted student loans from lenders, it must ensure that the lenders meet the federal requirements for collecting on the defaulted loans and for submitting default claims to the commission. Additionally, the commission must meet federal deadlines for paying lenders for defaulted loans and for requesting payment from the federal government. Of the 44 loans purchased by the commission that we reviewed, we found that 8 loans did not meet one of these federal requirements for reimbursement and an additional loan did not meet two of these federal requirements for reimbursement. We found the following specific problems:

- For 5 of the loans, the lender did not perform at least one of the procedures required for collecting loans while the lender still held the loans. Despite this lapse in required collecting efforts, the commission did not subsequently limit the interest it paid to the lenders, as required by federal guidelines.

- For one of the loans, the commission's service contractor accepted a default claim that the lender had submitted 5 days after the required 90-day deadline. We considered the date the default claim was received by the service contractor as the submission date because the date the default claim was signed differed significantly from the date received and the postmark was not available. The commission's claim procedures manual provides that the date the default claim was received be used in this situation.

- For 3 of the loans, the commission did not pay the lender within the required 90 days of the date that the lender submitted the default claim. Rather, it paid the lender 6 to 20 days after the required deadline. In our audits of the last two years, we also reported instances when the commission did not pay the lender within the required 90 days. Although we noted this problem again during this audit, the commission was late by fewer days this time than in the previous year.

- For one of the loans, the commission submitted a request for payment to the federal government 9 days earlier than the required 90 days after the default date.

Failure to ensure that loans meet federal requirements could jeopardize federal reimbursements.

Criteria

The Code of Federal Regulations, Title 34, Section 682.406(a), lists the conditions that must be met to qualify a defaulted student loan for federal reimbursement. These conditions include requirements that the lender exercise due diligence in collecting the loan; that the lender submit a default claim within 90 days of default; that the commission pay the lender within 90 days of the date the lender submitted the claim; and that the commission request payment from the federal government no earlier than 90 days after the default date.

The United States Department of Education Bulletin 88-G-138 provides for the limitation of interest in certain instances when collection procedures were not followed.

Recommendation

The commission should ensure that all defaulted student loans it submits for reimbursement to the federal government meet federal requirements.

Incorrect Calculation of Interest Paid to Lenders

Finding

For 13 of 44 loans that we reviewed, the commission paid lenders incorrect amounts of interest on the defaulted loans that it purchased from them. Specifically, the commission overpaid two lenders approximately $1,285. On one loan, the commission overpaid a lender $643 because the service contractor used the incorrect date when computing interest. On the second loan, the commission overpaid a lender $642 because the service contractor did not stop interest 60 days after the rejection of the lender claim, as the commission's policy requires. The commission paid the lender for 1,189 days of interest when it should have paid the lender for 445 days.

Additionally, the commission underpaid interest to 11 lenders by approximately $471. For 7 of the 11 loans, the service contractor calculated interest using a fixed rate instead of the appropriate variable rate. Using the incorrect rate caused the commission to underpay lenders $138. For 4 of the 11 loans, the commission underpaid the lenders $333 because the service contractor did not calculate the correct amount of days that interest should have been limited to when it assessed penalties because lenders did not follow all required collection procedures.

Because the commission requests reimbursement from the federal government for both the amount of the defaulted loan and the related interest paid to the lender, these errors caused the commission to request incorrect reimbursements. Although the errors we identified resulted in a net overpayment from the federal government of only $814, the errors could be indicative of procedural deficiencies that, if not corrected, could result in larger incorrect reimbursement claims in the future.

Criteria

The Code of Federal Regulations, Title 34, Sections 682.404 and 682.405, provides that the federal government will reimburse a guarantee agency up to 100 percent for its losses. Section 682.404(a)(2) defines losses as the amount of unpaid principal and accrued interest the agency pays on a default claim filed by a lender on a reinsured loan, minus payments made by, or on behalf of, the borrower after the lender's claim is paid and before the federal government reimburses the agency.

Recommendation

The commission should ensure that it pays lenders the correct amount of interest so that the commission can request the correct reimbursement from the federal government.

Federal Quarterly Report Not Reconciled With Accounting Records

Finding

The commission's federal quarterly report for April through June 1990 contains information that does not reconcile with the commission's accounting records. Specifically, the commission reported in the quarterly report $487,918 more in lender claims paid and $176,555 less in collections received than it recorded in its accounting records. The commission did not provide us with a reconciliation between the quarterly report and the accounting records, and we could not determine whether the quarterly report, accounting records, or both were inaccurate.

We reported a similar weakness in our audits for each of the last four years. In our previous report, dated October 1989, we stated that the commission's chief of administrative services commented that the commission's new financial aid processing system, to be implemented in fiscal year 1989-90, would provide for reconciliation of the federal reports with the accounting records. However, as of December 1990, the commission had not implemented the new system.

Criteria

Circular A-102, Subpart C, of the federal Office of Management and Budget requires the State to account for grant funds in accordance with state laws and procedures. Further, the State Administrative Manual, Section 20014, requires agencies receiving federal funds to reconcile federal financial reports with the official accounting records.

Recommendation

The commission should reconcile its quarterly reports with its accounting records.

Guaranteed Student Loans Exceeded Allowable Loan Limits

Finding

During fiscal years 1988-89 and 1989-90, the commission guaranteed student loans that exceeded allowable federal loan limits. The State reports that the commission guaranteed 401,892 loans during fiscal year 1988-89 and 371,179 loans during fiscal year 1989-90. We performed a computer search of the commission's borrower files for these two years to help identify possible exceptions of loans guaranteed in excess of allowable federal loan limits.

As shown on Table 1 below, for the 73 borrower files that we reviewed, the commission guaranteed loans that exceeded limits for 15 borrowers. The 15 loan guarantees exceeded the limits by approximately $29,000. Noncompliance with federal loan limits could result in a loss of state funds if the borrower defaults because the federal government will not purchase the portion of defaulted loans above the limit.

Table 1 **Results of Loan-Limit Testing Fiscal Years 1988-89 and 1989-90**

Type of Loan/ Type of Limit	Potential Exceptions, Computer Identified	Potential Exceptions Reviewed	Guaranteed Loans That Exceeded Limits	Loans for Which We Could Not Conclude
Stafford:				
Individual loan	6	6	5	0
Academic year	111	10	5	0
Cumulative	70	25	2	0
Supplemental Loans for Students and Parent Loan Program:				
Individual loan	0	0	0	0
Academic year	a	22	3	4
Cumulative	b	10	0	0
Total		73	15	4

[a] The number of potential exceptions identified by the computer is misleading. The commission's computer file defined an academic year as 335 days. However, schools may measure the academic year differently depending on the type of academic program they administer.

[b] The number of potential exceptions identified by the computer is misleading because our computer search did not recognize instances when a parent borrower's account included more than one student.

For 3 of the 15 loans, the commission manually combined two loan accounts into one account because information had previously been reported incorrectly under two account numbers. According to the manager of the Preclaim, Claim, and Bankruptcy Division, when the commission manually combines accounts, it does not reevaluate the amounts borrowed. For an additional 3 of the 15 loans, the commission had incorrectly entered information into the system. For 2 of the 15 loans, the commission manually adjusted the student's grade level but did not change the guarantee amount on its computer files. We could not determine why the commission guaranteed the remaining 7 loans in excess of the limits.

We also could not determine whether 4 of the 32 borrowers of Supplemental Loans for Students (SLS) we reviewed exceeded the limits. Three of these 4 borrowers had loans certified in both 1989 and 1990 that were for the same academic year. When we compared the loans of these three borrowers to the limits, we could not conclude because the federal regulations are unclear as to whether loans certified before January 1, 1990, should be included with loans certified after January 1, 1990, the date that new loan limits went into effect. Further, we could not determine whether loans to one borrower exceeded the limit within a specified academic year because the school the borrower attended went out of business, and thus, we could not obtain all the information we needed to reach a conclusion.

Criteria

The United States Code, Title 20, Sections 1078, 1078-1, and 1078-2, provides for specific loan limits for guaranteeing Stafford, SLS, and Parent Loan Program loans based on the student's grade level, the length of the course in which the student is enrolled, and the total outstanding principal for each loan program.

Recommendation

The commission should guarantee only loans that are within the applicable federal limits.

Ineffective System for Preventing a Collection Agency From Providing Conflicting Services on the Same Loan

Finding

The commission does not have an effective system to prevent a collection agency from contracting to collect on the same student loan for which the agency had provided supplemental preclaims assistance. Supplemental preclaims assistance consists of specified procedures, performed before the commission pays lenders for defaults on the loans, to persuade severely delinquent borrowers to repay their loans. For one of the 10 loans we reviewed, the same collection agency that provided supplemental preclaims assistance also contracted to collect on the loan. If the commission does not have an effective system to prevent collection agencies from performing conflicting services on the same loan, the federal government could refuse to reimburse the commission for the cost of supplemental preclaims assistance for loans affected by the conflicting services.

We reported a similar weakness in our audit for fiscal year 1988-89. In our previous report, dated October 1989, we stated that the commission's chief of administrative services commented that the commission's staff had determined the cause of the problem and had accordingly changed its procedures for assigning loans to collection agencies. In addition, in November 1989, the commission's service contractor attempted to identify any accounts that had supplemental preclaims assistance provided by the same agency that was collecting on a defaulted loan. Staff of the service contractor reported that it requested collection agencies to cancel and return all erroneously assigned accounts for reassignment.

However, the erroneously assigned account we noted indicated that the commission had not fully corrected the problem because this account would have been cancelled and returned to the service contractor if the system was working correctly. After we brought this matter to its attention, the commission further reviewed the corrections the service contractor made and found that the corrective actions did not work in certain situations.

Criteria

The Higher Education Act, Section 428(c)(6)(C) (iii), requires that supplemental preclaims assistance be done by an organization or entity that does not have a contract with the commission to perform collection activities for the same loans in the event of default.

Recommendation

The commission should ensure that loans are not assigned for collection activities to the same collection agency that provided supplemental preclaims assistance.

Insufficient Documentation That Defaulted Loans Are Properly Reported to National Credit Bureaus and Insufficient Reporting to National Credit Bureaus

Finding

There was insufficient documentation that the commission had reported defaulted loans to all three of the national credit bureaus the commission contracts with to ensure sufficient geographical coverage. Because the commission's records indicate only that information has been sent to credit bureaus but does not indicate the specific credit bureaus the commission reported to, we reviewed the credit bureaus' records also. For 9 of the 12 loans we reviewed, either one or two of the credit bureaus did not have any record of defaulted loans being reported. Further, for one of the 12 loans we reviewed, neither the credit bureaus' nor the commission's records showed any indication that the commission notified any of the credit bureaus of the default. Without such documentation, we cannot conclude that the commission properly reported the loans.

We also found that the commission did not report the date of loan default as required by federal regulations for any of the 12 loans that we reviewed.

If defaulted loans are not properly reported or if information reported is not properly documented, a lender or other guarantee agency could use incorrect information when making or insuring loans. We reported a similar weakness in our audit for fiscal year 1988-89 when we reported that there was no evidence that the commission had reported 3 of 12 loans we reviewed.

Criteria

The Code of Federal Regulations, Title 34, Section 682.410(b)(3), requires the commission to report to all national credit bureaus the default date, information concerning loan collection, and the date the loan is fully repaid or discharged.

Recommendation

The commission should maintain records sufficient to document that it has properly reported defaulted loans to all appropriate credit bureaus.

Noncompliance With Additional Federal Requirements

Findings and Criteria

We noted the following instances when the commission did not always comply with administrative requirements of the federal government.

- The commission did not report at least $333,000, representing nearly one percent of total collections of defaulted student loans, within the required 60 days. The Code of Federal Regulations, Title 34, Section 682.404(e)(4), requires the commission to submit the federal share of borrower payments within 60 days of receipt.

- The commission submitted its federal annual report 9 days after the required date. The United States Department of Education's instructions for preparing the federal reports require the commission to submit the annual report within 60 days after the end of the federal fiscal year.

- The commission understated the federal advance portion of its fund balance by approximately $10,000 because of three errors it made calculating interest earned on a federal advance. The Code of Federal Regulations, Title 34, Section 682.410(a)(4) (ii), requires a guarantee agency to account separately for federal advances obtained under Section 682.403 and any interest earned on the advances.

Section 682.410(a)(4)(i) requires that guarantee agencies use these funds only to pay default claims.

Recommendations

The commission should improve its compliance with each of the federal requirements.

California State Department of Education

We reviewed the financial operations and related internal controls of the California State Department of Education (department) and the department's administration of 13 federal programs. These programs are the U.S. Department of Agriculture grants, Federal Catalog Numbers 10.550, 10.553, 10.555, and 10.558; the U.S. Department of Labor grant, Federal Catalog Number 17.250; the U.S. Department of Education grants, Federal Catalog Numbers 84.010, 84.011, 84.027, 84.048, 84.151, 84.173, and 84.186; and the U.S. Department of Health and Human Services grant, Federal Catalog Number 93.025 (formerly Federal Catalog Number 13.786).

Insufficient Controls Over Cash

Finding

The department did not maintain sufficient controls over certain areas of cash. We noted the following specific deficiencies:

- For cash receipts other than federal grant money deposited directly with the State Treasurer's Office, the department was late in notifying the State Treasurer's Office which fund to credit with the department's receipts. For 28 of 30 receipts received from July 1989 through June 1990 that we reviewed, the department was 9 to 75 working days late in notifying the State Treasurer's Office, for an average of 43 working days late. When the department does not notify the State Treasurer's Office which fund to credit for money that it receives, it cannot use the money to pay current obligations.

  We observed a similar weakness during our financial audits for fiscal years 1986-87 through 1988-89. In May 1990, the department stated this late notification was an on-going problem due to reporting delays inherent in the California State Accounting and Reporting System (CALSTARS), the department's accounting system. The department also responded that, to meet the requirements of the State

Administrative Manual, Section 8091, it has established a team comprised of accounting office managers and staff to develop an alternative to CALSTARS.

- For 11 of 12 months in fiscal year 1989-90, the department prepared its monthly bank reconciliation between 6 weeks and 7 months after the month that was covered by the reconciliation. Failure to prepare the bank reconciliations promptly can delay the detection of errors and irregularities in the records of the department or of the State Controller's Office.

- The department did not adequately reconcile the checks-written log with the checks-signed log for general cash checks and revolving fund checks. During our review of the fiscal year 1989-90 logs, the status for 13 of the checks recorded in the checks-written log did not agree with the status of checks in the checks-signed log. Although the department reconciles the number of checks written and checks signed to the logs daily and monthly, it does not appear that it reconciles the actual check numbers. As a result, the department cannot be certain that it can account for all checks.

  We observed a similar weakness during our financial audits for fiscal years 1985-86 through 1988-89. In May 1990, the department responded that the necessary procedural changes have been implemented to include the reconciliation of check numbers to allow the department to account for all checks. In addition, the department stated that accounting office staff have received training on the revised procedures and supervisors are reviewing the reconciliations to ensure that the procedures are being followed. In November 1990, the department began implementing the new procedures.

Criteria

The State Administrative Manual, Section 8091, requires the department to notify the State Treasurer's Office which fund to credit within 30 days of collection. For accumulated receipts of $25,000 or more, the State Administrative Manual, Section 8091, requires the department to send notification no later than the first day of the week following the accumulation of that amount. Further, the State Administrative Manual, Section 8060, requires that bank accounts be reconciled promptly at the end of each month. Finally, the State Administrative Manual, Section 8081, requires the department to reconcile the checks-written log with the checks-signed log each month to ensure that the department accounts for all checks.

Recommendation

The department should comply with the provisions of the State Administrative Manual, Sections 8060, 8081, and 8091.

Weak Controls Over Accounts Receivable

Finding

The department has not completed the development of comprehensive written policies and procedures for monitoring and collecting accounts receivable. We observed a similar weakness during our financial audits for fiscal years 1983-84 through 1988-89. In May 1990, the department responded that the development and implementation of a comprehensive accounts receivable plan remains a high priority of the accounting office. The department's revised date for completion was June 30, 1990. As of January 1991, an accounts receivable policy has only been proposed. Unless the department develops and follows a policy for monitoring and collecting accounts receivable, it diminishes the control over its receivables and, thus, increases the risk that some receivables will become uncollectible.

Also, we noted that the department's accounts receivable reports for some accounts showed a zero balance although no payments had been received. Because the reports from May through October 1990 contained this error, the accounting office did not send any status reports to the department's programs for follow-up. If the accounting office does not send the reports to the programs or if the reports contain inaccurate information, the program administrators cannot follow up on delinquent accounts and the department may not collect the receivables.

Criteria

The State Administrative Manual, Section 8710.1, requires each department to develop collection procedures that will ensure prompt follow-up on receivables. The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation

The department should implement a comprehensive policy for monitoring and collecting accounts receivable and for maintaining accurate reports.

Insufficient Documentation of Economic Impact Aid Entitlement

Finding

The department did not sufficiently document the calculation for the Economic Impact Aid (EIA) entitlement. The EIA entitlement provides funds to school districts for programs for educationally disadvantaged youth and for bilingual education. The funding for the EIA entitlement is based on a complex formula that uses transiency, poverty, and bilingual student data. The transiency data is used to calculate the transiency ratio, which measures the number of children who enroll in school, then move to another area and enroll at another school within the same school year. The transiency ratio is calculated by averaging the data from the three most recent years. For EIA entitlements for fiscal year 1989-90, the data the department used to calculate the transiency ratio for fiscal years 1986-87 and 1987-88 did not agree with the data reported by the districts. The department could not explain the reason for the difference.

To calculate the EIA entitlement, the department also uses data about those school age children living in poverty in a school district who do not receive Aid to Families with Dependent Children. This data was reported in the 1980 United States Census, which reported the data by county, not by school district.

Therefore, the department had to convert the data from county to school district. The department could not provide documentation to support its conversion of the 1980 census data from county to school district. Without sufficient documentation of the EIA entitlement calculations, the department cannot demonstrate that the EIA entitlement was calculated appropriately.

Criteria

The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control, including a system of authorization and recordkeeping procedures, is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation

The department should document all data used to calculate the EIA entitlement.

Errors in Allocating Administrative Costs

Finding

The department did not accurately allocate administrative costs between the federal Chapter 1 Program--Local Educational Agencies and the State Compensatory Education Program. The federally approved rates for fiscal year 1989-90 were 83 percent for the federal share and 17 percent for the state share. For fiscal year 1988-89, the respective rates were 79 percent for the federal share and 21 percent for the state share. However, the department allocated the costs for both fiscal years based on the federally approved rates for fiscal year 1987-88. The rates for that year were 77 percent for the federal share and 23 percent for the state share. As a result, the department overcharged the State's General Fund for fiscal year 1989-90 by approximately $58,000 and for fiscal year 1988-89 by approximately $8,400. Conversely, the department undercharged the federal government for both fiscal years by those amounts.

Criteria

The federal Office of Management and Budget, Circular A-87, states that, to be allowable under a grant program, costs must be necessary and reasonable for the proper and efficient administration of grant programs. In addition, Circular A-87 states that allocation of joint costs must be supported by formal accounting records that will substantiate the propriety of eventual charges.

Recommendation

To conform with the federally approved rates, the department should adjust for the error in allocating administrative costs for the federal Chapter 1 Program--Local Educational Agencies and the State Compensatory Education Program.

Inconsistency in Resolving Instances of Noncompliance With Federal and State Laws and Regulations

Finding

The department did not consistently require resolution of instances of noncompliance with federal and state laws and regulations identified in audit reports of subrecipients. A "subrecipient" is any person, government department, local education agency, or establishment that receives federal financial assistance to carry out a program through a state government but is not a direct beneficiary of such a program.

We reviewed 130 audit reports for subrecipients' compliance with federal and state laws and regulations. Forty-seven of these audit reports identified instances in which subrecipients did not comply with federal laws and regulations. Of these 47, the department ensured that the subrecipients properly resolved the instances of noncompliance identified in 41 reports. However, the department did not ensure that the subrecipients properly resolved the instances of noncompliance with the National School Lunch Program identified in 2 reports. Moreover, it did not ensure that the subrecipients resolved within six months the instances of noncompliance with the Child and Adult Care Food Program identified in 3 reports and an instance of noncompliance with the Federal, State, and Local Partnerships for Educational Improvement program identified in one report.

We also found that 17 of the 130 audit reports we reviewed identified instances in which subrecipients did not comply with state laws and regulations. Of these 17, the department ensured proper resolution for instances of noncompliance in 14 reports. However, the department did not ensure proper resolution for instances of noncompliance related to attendance accounting in 3 reports.

Without proper follow-up on instances of noncompliance with federal and state laws and regulations reported in audits of subrecipients, the department cannot be certain that subrecipients are complying with federal and state laws and regulations.

We observed similar weaknesses during our financial audits for fiscal years 1987-88 and 1988-89. The department responded that it had revised its procedures to provide prompt resolution of audit exceptions.

Criteria

According to the federal Office of Management and Budget, Circular A-128, state or local governments that allocate $25,000 or more of federal financial assistance to a subrecipient must determine whether subrecipients spent federal financial assistance in accordance with applicable laws and regulations. Also, for instances of noncompliance with federal laws and regulations, this circular requires that state or local governments ensure that appropriate corrective action is taken within six months of receipt of the audit reports.

The California Education Code, Section 41020.6, states that the department shall report annually the actions it takes to eliminate audit exceptions and comply with management improvement recommendations in audit reports of subrecipients. We interpret this section to mean that the department must ensure that subrecipients take appropriate corrective action to resolve instances of noncompliance identified in audit reports.

Recommendation

The department should ensure that subrecipients correct within six months instances of noncompliance with federal and state laws and regulations identified by auditors.

Failure To Obtain Audit Reports for the State Legalization Impact Assistance Grants Program

Finding

The department did not obtain audit reports from 27 of the 66 private, nonprofit organizations participating in the State Legalization Impact Assistance Grants (SLIAG) program. The department is responsible for ensuring that organizations meet the federal requirement to undergo an independent audit. Unless the department obtains the audit reports, it cannot be sure that organizations participating in the SLIAG program complied with this requirement. Further, the department cannot determine if the organizations complied with the terms and conditions of the SLIAG program.

Criteria

The federal Office of Management and Budget, Circular A-110, requires private, nonprofit organizations that receive federal funds to have independent audits conducted at least every two years. Also, Circular A-128 requires the department to determine whether the private, nonprofit organizations meet the audit requirements of Circular A-110 and whether they spend federal assistance funds in accordance with applicable laws and regulations.

Recommendation

The department should ensure that the organizations undergo independent audits at least every two years in compliance with federal requirements.

Insufficient Monitoring of Subrecipients and Contractors That Participate in the Food Distribution Program

Finding

The department did not sufficiently monitor subrecipients, such as charitable institutions and nonprofit summer camps, and food processing contractors that participate in the Food Distribution Program. For example, the department did not perform compliance reviews within the required five-year period for 4 of the 24 subrecipients that we tested. We observed a similar weakness during our financial audits for fiscal years 1986-87 through 1988-89. The department responded that it will review subrecipients at least once every four years.

Also, the department did not require one of the 24 subrecipients that we tested to promptly submit a corrective action plan for instances of noncompliance that the department noted during its compliance review. Moreover, the department did not enter into annual written agreements for program participation with 2 of the 24 subrecipients that we tested.

In addition, the department did not sufficiently monitor contractors that participate in the Food Distribution Program. Specifically, the department did not perform on-site reviews for 3 of the 62 contractors participating in the Food Distribution Program during fiscal years 1988-89 and 1989-90.

If the department does not sufficiently monitor subrecipients and contractors and does not require subrecipients to submit corrective action plans for instances of noncompliance, the department cannot ensure that they comply with federal requirements. Further, written agreements ensure that subrecipients agree to the terms and conditions of the program.

Criteria

The Food and Nutrition Service, Instruction 113-3, issued by the U.S. Department of Agriculture on December 16, 1982, requires that the State review subrecipients receiving donated food at least once every five years for compliance with Title VI of the Civil Rights Act of 1964.

The California Government Code, Section 13402, requires state agencies to establish and maintain a system of administrative controls. According to the California Government Code, Section 13403, the purpose of these administrative controls is to safeguard assets, promote operational efficiency, and encourage adherence to prescribed managerial policies. The department's management policy requires subrecipients to promptly submit plans of corrective action after the department has conducted its compliance review of an agency.

The Code of Federal Regulations, Title 7, Section 250.12(b), requires the department to enter into written agreements with subrecipients and that the agreement be in effect for no longer than one year.

The Code of Federal Regulations, Title 7, Section 250.19(b)(ii), states that an on-site review must be performed at least once every two years for all contractors except those who are multi-state contractors as defined in Section 250.3. The code also requires that no less than 50 percent of the contractors be reviewed each year.

Recommendation

The department should perform the required number of compliance reviews. The department should also require subrecipients to submit corrective action plans for instances of noncompliance noted during its compliance reviews. Further, the department should enter into written agreements with each subrecipient annually.

Insufficient Monitoring of Local Education Agencies Participating in the Drug-Free Schools and Communities Program

Finding

In August 1989, the United States Department of Education (USDOE) reported that the department did not formally monitor local education agencies (LEAs) participating in the Drug-Free Schools and Communities program. The USDOE recommended that the department develop and implement a plan to monitor its LEAs. To comply with this requirement, the department will require county offices of education to include in their application for funding for fiscal year 1991-92 a plan for monitoring each LEA a minimum of once every three years. The department will also require county offices of education and LEAs to include in their applications for funding a progress report for the previous fiscal year. In addition, the department has employed a contractor to evaluate the program and determine if program objectives are being achieved.

Criteria

The Code of Federal Regulations, Title 34, Section 80.40(a), requires grantees to monitor activities to ensure the LEAs comply with applicable federal requirements and achieve performance goals.

Recommendation

The department should determine if the monitoring procedures of the county offices of education are sufficient to ensure that the LEAs comply with applicable federal requirements and that they achieve performance goals.

Insufficient Information Contained in Applications for the Drug-Free Schools and Communities Program

Finding

The department did not require LEAs participating in the Drug-Free Schools and Communities program to include in their program applications information relating to services to be provided to students enrolled in private schools. However, the department will require this information in the LEAs' applications for fiscal year 1991-92.

Criteria

The Code of Federal Regulations, Title 34, Section 76.656, requires subrecipients to include in their applications information relating to services that the subrecipients will provide to students enrolled in private schools.

Recommendation

The department should require the LEAs to include in their applications information related to the services to be provided to students enrolled in private schools.

Insufficient Monitoring of Payments for the Drug-Free Schools and Communities Program

Finding

The department did not sufficiently monitor payments to LEAs participating in the Drug-Free Schools and Communities program. Specifically, the department may not have limited payments to LEAs to their immediate cash needs because it did not determine whether LEAs spent all the amounts paid to them for the program. For fiscal year 1989-90, rather than limiting payments to periodic payments as the department does for other federal programs, the department paid the entire amount to most LEAs in February 1990. Moreover, the department did not require LEAs to report funds spent for the fiscal year. Without expenditure reports, the department cannot determine whether the LEAs spent all funds paid or should return unused funds.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), requires that the timing and amount of cash advances be as close as is administratively feasible to the actual disbursements by the recipient organization. The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation

The department should implement procedures to limit payments to the immediate needs of the LEAs. Also, the department should require the LEAs to report the use of funds.

Insufficient Controls for the Handicapped--Preschool Grants Program

Finding

The department did not follow its control procedures for the payment to one of the 30 Special Education Local Plan Areas (SELPA) that we reviewed that participated in the federal Handicapped--Preschool Grants program. Specifically, the department authorized an advance to the SELPA for fiscal year 1990-91 before receiving the SELPA's final expenditure report for fiscal year 1989-90. The department requested the SELPA's report after we informed the department that it had not received the report. Because the SELPA did not submit its final expenditure report, the department should not have authorized payment of the SELPA's current year funds until the SELPA submitted the report. When it does not follow its own control procedures, the department may jeopardize its ability to properly monitor the SELPA's use of federal grant monies and to enforce pertinent federal laws and regulations.

We reported a similar weakness during our financial audit for fiscal year 1988-89. The department responded that it would revise its procedures to ensure that the policy of withholding funds until expenditure reports are received is adhered to.

In addition, the department did not sufficiently monitor the reports submitted by the SELPAs. This insufficient monitoring caused the payment ratio used for one of the 30 SELPAs that we reviewed to be inaccurate. As a result, the department overpaid one SELPA approximately $49,000. The department added to its automated program a procedure designed to verify its entitlement calculations.

Criteria

The United States Code, Title 20, Section 1232d(b)(1), requires the State, in its application for funds, to give assurances that it will administer the program in accordance with all applicable statutes, regulations, program plans, and applications. In addition, the Code of Federal Regulations, Title 34, Section 76.722, permits a state to require subrecipients to submit reports that the state needs to carry out its responsibilities under the grant program. Moreover, the department specifies in its special grant conditions that the failure of a SELPA to submit a final expenditure report will result in the withholding of current year advances.

The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation

The department should adhere to its control procedures for payments to SELPAs. In addition, the department should monitor the reports submitted by the SELPAs to ensure their accuracy. Also, the department should recover the $49,000 that it overpaid to one of the SELPAs.

Noncompliance With Federal Requirements

Findings and Criteria

In the following instances, the department did not always comply with administrative requirements of the federal government:

- For 5 of 265 claims that we reviewed, the department held the related federal grant funds from 6 to 23 working days before disbursement to subrecipients. The average number of days between receipt and disbursement of these 5 claims was approximately 10 days. However, the average number of days between receipt and disbursement of funds for all claims that we reviewed was only 2.6 days. Also, for 13 other claims, the department disbursed money from one to 11 days before receiving the federal grant money. The Code of Federal Regulations, Title 31, Section 205.4(a), requires that the timing and amount of cash advances be as close as administratively feasible to the actual disbursement by the recipient organization. We observed similar weaknesses during our financial audit for fiscal years 1987-88 and 1988-89.

- For 2 of the 25 entitlements for the Drug-Free Schools and Communities program that we reviewed for fiscal year 1989-90, the enrollment data the department used to calculate the entitlements did not agree with the enrollment data maintained by the department's Educational Demographics Unit. As a result, we could not determine if the department used the correct enrollment data to calculate the entitlements. The Code of Federal Regulations, Title 34, Sections 80.42(b)(1) and (c)(1), require the department to retain records for three years from the date it submits its final expenditure report.

- For one of the 21 subrecipients participating in the National School Lunch and Breakfast Programs that we reviewed for fiscal year 1989-90, the department allowed 24 days beyond the required 90 days to elapse before performing the closing review. The Code of Federal Regulations, Title 7, Section 210.18(i)(6)(iii), states that a corrective action plan must be written, signed by the proper official of the school food authority, and submitted to and approved by the state agency within 60 days following the final meeting to discuss the results of a review. State agencies may extend this deadline to 90 days. We observed a similar weakness in our financial audits for fiscal years 1987-88 and 1988-89.

- For 2 of the 30 subrecipients participating in the Child and Adult Care Food program that we reviewed, the department did not quite meet the 15 percent requirement to review child care centers. For the 2 subrecipients, the department reviewed 14.3 percent, or one of 7, of the centers and 14.8 percent, or 4 of 27, of the centers. The Code of Federal Regulations, Title 7, Section 226.6(l)(1), requires state agencies to include at least 15 percent of subrecipients' child care centers in administrative reviews.

Although individually these deviations may not appear to be significant, they do represent noncompliance with federal regulations, which are designed to protect the public's resources from abuse.

Recommendation

The department should improve its compliance with each of the federal requirements.

Noncompliance With State Requirements

Findings and Criteria

In the following instances, the department did not always comply with administrative requirements of the State.

- For 17 of the 30 cash receipts that we reviewed, the department deposited the receipts one to ten working days late. The State Administrative Manual, Section 8030.1, requires that receipts exceeding $5,000 be deposited on the day of receipt unless they are received late in the day, in which case they may be deposited the next working day. We observed a similar weakness during our financial audit for fiscal year 1988-89.

- For one of the 30 cash receipts that we reviewed, the department recorded the receipt in the monthly Cash Receipts and Disbursements Register incorrectly. As a result, cash in the General Fund was understated and cash in the Special Deposit Fund was overstated by approximately $1,700. The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control, including a system of authorization and recordkeeping procedures, is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

- Three of the 14 revolving fund travel advances that we reviewed have been outstanding for over six months. The State Administrative Manual, Section 8116, requires an agency to reimburse its revolving fund and to clear travel advances from the records when employees submit their travel-expense claims. If an advance exceeds an employee's travel-expense claim, the employee will be required to reimburse the revolving fund for the difference promptly. We observed a similar weakness during our financial audits for fiscal years 1987-88 and 1988-89.

- Starting in fiscal year 1988-89, the department began using a new funding formula to calculate the apportionment of Project Work-Ability I funds for sites established in fiscal year 1988-89 and thereafter. The new funding formula was adequately supported. However, for sites that existed before fiscal year 1988-89, the department continued to use its previous funding formula for which the department did not provide adequate support. The department informed the sites that it would fund them using the new formula beginning in fiscal year 1991-92. The California Government Code, Sections 13402 and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control, including a system of authorization and recordkeeping procedures, is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

- The department did not promptly transfer to the State's General Fund reimbursements representing the federal government's share of service costs provided by central service agencies. These costs are calculated under the Statewide Cost Allocation Plan (SWCAP), which is the plan that each state agency uses to pay for its share of the State's cost for central services. The department transferred the SWCAP recoveries for the period from July through November 1989 on March 5, 1990, and for the period from December 1989 through June 1990 on December 27, 1990.

  The California Government Code, Section 13332.01, requires agencies to recover SWCAP costs from the federal government. Although no deadline is expressly mandated, the State Administrative Manual, Section 8755.2, infers that a transfer of SWCAP recoveries to the State's General Fund within 30 days of the end of each quarter would be appropriate.

Although individually these instances of noncompliance may not appear to be significant, they are deviations from the State's system of internal controls, which is designed to ensure that the public's resources are not vulnerable to abuse.

Recommendation

The department should improve its compliance with each of the state requirements.

General Government

Office of Administrative Law

We reviewed the financial operations and related internal controls at the Office of Administrative Law (office).

Insufficient Record of Hours Charged to Other State Agencies

Finding

The office has not maintained sufficient records to demonstrate that prorata and SWCAP allocations to other state agencies to recover its costs are equitable. The prorata is the plan the Department of Finance uses to reimburse the State's General Fund for the special funds' share of the cost of the State's central services. The Department of Finance uses the SWCAP to reimburse the General Fund for the federal programs' share of the State's costs of central services. As a central service, the office reviews administrative regulations announced by state regulatory agencies to determine whether the regulations are authorized by statute and are consistent with other laws. However, the office could not provide us with records of how its employees used their time or how it supported its estimates of time usage for fiscal years 1988-89 and 1989-90.

Criteria

The federal Office of Management and Budget, Circular A-87, Attachment B, B.10.b, requires that amounts charged to more than one grant program or other cost objective be supported by appropriate time distribution records. The State Administrative Manual, Section 8753, requires that costs of central services be apportioned on the basis of services provided.

Recommendation

The office should maintain appropriate time records to support the data it reports to the Department of Finance for prorata and SWCAP allocations.

Weaknesses in Control Over Cash Receipts

Finding

The office does not record dates of receipt for cash collections. Approximately twice each week, the office prepares a dated transmittal, which lists each receipt making up the total deposit. However, the transmittal does not indicate the date of receipt for each item. During fiscal year 1988-89, the office made 119 deposits totaling approximately $122,200.

Without recording the dates it receives cash collections, the office cannot ensure that it promptly deposits funds. Prompt deposit of cash receipts reduces the risk of loss from fire or theft and prevents the loss of interest earnings.

Criteria

The State Administrative Manual, Section 8093, requires that agencies normally record the date of receipt for each cash collection.

Recommendation

The office should record the date of receipt for each cash collection.

Board of Chiropractic Examiners

We reviewed the financial operations and related internal controls at the Board of Chiropractic Examiners (board).

Insufficient Controls Over Cash Receipts

Finding

The board did not maintain sufficient controls over cash receipts. We noted the following specific deficiencies:

- The board did not always deposit cash receipts promptly or endorse checks when it received them. We found that at least $225,000 of approximately $980,000 in cash receipts had been deposited from 3 to 49 days late during fiscal year 1988-89, and at least $175,000 of approximately $980,000 in cash receipts had been deposited from 4 to 49 days late during fiscal year 1989-90. These late deposits included 227 checks totaling more than $21,000 that the board did not restrictively endorse until at least 38 days after it received them. The board deposited the cash receipts we examined an average of 20 days after they were received. When the board does not deposit receipts promptly or endorse checks when it receives them, an increased risk of loss exists from theft or fire. These late deposits also resulted in a loss of interest earnings to the State estimated to be at least $1,912; and

- The board did not always record the dates of receipt of cash collections. Specifically, in some instances, the board recorded the date it deposited the collections rather than the date it received them. Thus, we could not always determine the elapsed time between the date of receipt and the date of deposit. Because the date of receipt was not always recorded, the potential exists of recording cash receipts and related revenues in the wrong year, and thus, misstating the financial statements.

According to the executive director of the board, the board receives a large number of cash receipts during the time immediately preceding the statutory deadlines for license renewals and examination fees. Further, she stated that this large volume of receipts in a short time restricted the board's ability to promptly process some of the cash receipts that we tested.

Criteria

The State Administrative Manual, Section 8030.1, requires that cash receipts exceeding $5,000 be deposited on the day of receipt unless it is not practical to deposit them by closing time, in which case they may be deposited by the next working day.

The State Administrative Manual, Section 8023, requires checks to be restrictively endorsed for deposit as soon as practicable after receipt, but no later than the end of the working day.

The State Administrative Manual, Section 8099, states that the State is vitally concerned with maximizing its interest earnings and that interest earnings can be maximized by the earliest practical deposit of receipts. Also, the State Administrative Manual, Section 8092, states that a report of collections normally will include the date of collection.

Recommendations

The board should make every effort to restrictively endorse checks on the date received, to deposit the cash receipts promptly, and to record the date received in the report of collections. To accomplish these activities, the executive director should consider the temporary assignment of other staff to cashiering duties during periods when the board receives a large volume of cash receipts.

Insufficient Controls Over Accounts Receivable

Finding

The board did not maintain complete accounting records of amounts owed by licensees for reimbursement of investigative costs and did not monitor these accounts receivable to ensure that it collected all amounts owed by licensees. We noted the following specific deficiencies:

- The board did not establish an accounts receivable for reimbursement of amounts owed by licensees for investigative costs when an administrative hearing decision or stipulation specified a final amount. Instead, the board recorded reimbursements when it received payments. We found that five of the board's licensees owed $17,309 to the board for reimbursement of investigative costs; of this amount, $9,202 was being contested, and $8,107 was deemed collectible as of June 30, 1989. The board did not report these receivables or accrue the collectible amounts in its year-end financial reports. As a result, at June 30, 1989, it understated its accounts receivable, provision for deferred receivables, and reimbursements by $17,309, $9,202, and $8,107, respectively; and

- The board did not monitor its accounts receivable for reimbursement of investigative costs to ensure that it collected all amounts owed by licensees. Specifically, one licensee owed $1,425 as of June 4, 1988, had paid $425 as of June 30, 1989, and still owed $1,000 at June 15, 1990, even though the two-year period for required repayment had elapsed. Without effective monitoring of accounts receivable, the board cannot ensure that it collects all amounts owed by licensees.

Criteria

The California Government Code, Sections 13402 and 13403, requires agency heads to ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

The State Administrative Manual, Section 8776.2, states that valid accounts receivable for reimbursements not received as of June 30 will be accrued. The State Administrative Manual, Section 8776.12, also states that contingent receivables will be recognized in the accounts at the time the claim arises. If a contingent receivable becomes a valid accounts receivable, it will be recognized as such in the accounts. Contested claims should be established as valid accounts receivable when they have been either brought to judgment or the contested amount has been converted to a certain sum by negotiation. Finally, the State Administrative Manual, Section 8710.1, requires each department to develop collection procedures that will ensure prompt follow-up on receivables.

Recommendations

The board should establish accounts receivable for reimbursement of investigative costs and record the total amount owed in the appropriate general ledger accounts. The board should record an accounts receivable when an administrative hearing decision or stipulation specifies a final amount. Further, at year end, the board should analyze its accounts receivables and accrue the amounts estimated to be collectible in the next fiscal year. Finally, the board should establish procedures for monitoring its accounts receivables to ensure that it collects all amounts owed to it.

State Board of Control

We reviewed the State Board of Control's (board) compliance with federal and state regulations for the Statewide Cost Allocation Plan (SWCAP) and state regulations for the Prorata Allocation Plan (Prorata).

Overstatement of Expenditures Reported

Finding

In its report to the Department of Finance, the board overstated its fiscal year 1988-89 central service expenditures for the Prorata and the SWCAP by about $19,400. Because of this error, the State's General Fund collected approximately $7,500 more for reimbursement of the board's central service costs than the fund should receive. Approximately $6,000 of the $7,500 is from the State's special funds, and about $1,500 is from federal programs. This overstatement occurred because the Department of General Services, which provides the board's accounting services, made an error in accumulating the total central service expenditures for the board.

Criteria

The federal Office of Management and Budget, Circular No. A-87, sets forth principles for determining the allowable costs of programs administered by the State under grants from the federal government. The principles are designed to provide that federally assisted programs bear their fair share of costs recognized under these principles, except where restricted or prohibited by law. No provision for profit or other increment above cost is intended. In addition, the State Administrative Manual, Section 8752, requires state agencies to recover full costs for goods or services provided to other state agencies.

Recommendation

The board should report the corrected expenditures to the Department of Finance no later than July 31, 1990, so that the Department of Finance can include the adjustments in the fiscal year 1991-92 SWCAP and Prorata. Further, the board should review the schedules of SWCAP and Prorata expenditures prepared by the Department of General Services for accuracy before submitting the schedules to the Department of Finance.

Office of Criminal Justice Planning

We reviewed the Office of Criminal Justice Planning's (office) administration of the U.S. Department of Education grant, Federal Catalog Number 84.186.

Lack of Procedures To Ensure That Funds Are Reaching the Appropriate Recipients

Finding

The office does not have procedures to properly ensure that expenditures of funds of the Drug-Free Schools and Communities Act of 1986 (DFSC) are reaching the appropriate recipients. The office uses the DFSC funds to administer its Suppression of Drug Abuse in Schools Program, California Gang Violence Suppression Program, and Comprehensive Alcohol and Drug Prevention Education program. Based on our review of guidelines for these programs, we noted that the office selects subrecipients that target areas identified with drug prevention or suppression, areas with problems of gang violence, and the student population of grades four through six. However, we found that the office did not require its subrecipients to provide specific information on how the high-risk-youth population, as defined by federal code, would be targeted, how they would ensure that 90 percent of the participants in the program are high-risk youth, and how they make provisions to include services and arrangements for the benefit of children and teachers of private nonprofit schools to ensure equitable participation. In addition, we found that the quarterly progress reports that the subrecipients submitted to the office did not describe if the services that the subrecipients provided have demonstrable benefits to individuals who are considered high-risk youth, as defined by federal code, and if they provided services to students and teachers of private nonprofit schools.

The office told us that when the interagency agreement between the Department of Alcohol and Drug Programs and the office was amended on December 8, 1989, language was added that specified the need to comply with Section 5122(b) of the DFSC. This section specifies that no more than 10 percent of non-high-risk youth may participate in DFSC-funded programs for high-risk youth. The language in the interagency agreement did not provide a definition of "high-risk youth." As a result, the office developed its Request for Proposals that required applicants to serve high-risk youth according to the office's program guidelines. However, Section 5122(b) of the DFSC contains a clear and specific definition of "high-risk youth" that differed substantially from the office's program guidelines.

The office also told us that school districts are required to comply with Section 5143 of the DFSC through a program administered by the State Department of Education. This section requires notification to private nonprofit schools that DFSC services are available to their students and teachers. The office added that entitlements awarded to school districts include a signed statement that certifies that the districts are complying with the requirement that private nonprofit schools be notified of DFSC services. Because the office awarded funds to school districts that signed the statements, the office determined that it would not require further evidence of compliance. However, when the school districts signed the statement, they certified that they were complying with the regulations for the funds provided by the State Department of Education and not for the funds of the programs administered by the office.

Because the office lacks procedures to ensure that expenditures of DFSC funds are reaching the appropriate recipients, the office may not be able to accomplish the objectives of the DFSC and ensure proper use of funds.

Criteria

The interagency agreement between the office and the Department of Alcohol and Drug Programs requires the office to comply with Section 5122(b) of the DFSC, codified as Title 20, Section 3192(b) of the United States Code. Under this section, the office is required to ensure that not less than 90 percent of the participants in its DFSC-funded programs be high-risk youth. Section 5122(b) defines a "high-risk youth" as an individual who has not attained the age of 21 years and who has one or more of the following characteristics: is at high-risk of becoming or has been a drug or alcohol abuser; is a school dropout; has experienced repeated failure in school; is pregnant; is economically disadvantaged; is the child of a drug or alcohol abuser; is a victim of physical, sexual, or psychological abuse; has committed a violent or delinquent act; has experienced mental health problems; has attempted suicide; has experienced long-term physical pain due to injury; or is a juvenile in a detention facility within the State.

The interagency agreement also requires the office to comply with Section 5143 of DFSC, codified as Title 20, Section 3223 of the United States Code. This section requires the office to make provisions to include services and arrangements for the benefit of children and teachers of private nonprofit schools and to ensure equitable participation.

Recommendation

The office should develop and implement procedures to ensure that the use of DFSC funds are for authorized activities as provided in federal laws and regulations.

Delay in Receipt of Federal Funds

Finding

The office does not always obtain prompt reimbursement from its federal Drug-Free Schools and Communities Act of 1986 (DFSC) grant for payments to subrecipients, including school districts and nonprofit community-based organizations. The office initially requests that the State Controller's Office pay the subrecipients from the office's general fund and then submits invoices for reimbursement from the State Department of Alcohol and Drug Programs. We found that as of February 1, 1991, the office had not requested more than $2.1 million of reimbursements for payments to subrecipients. At February 1, 1991, the $2.1 million of payments had been unreimbursed an average of 188 days from the date the office had requested the State Controller's Office to pay subrecipients. Because the office did not receive prompt reimbursements for the $2.1 million, the State may have lost more than $100,000 in interest. The office also caused the State to lose approximately $27,000 in interest earnings on payments reimbursed prior to February 1, 1991.

Criteria

The State Administrative Manual, Section 0911.4, requires the state agencies to secure prompt reimbursement from grant funds for goods and services provided.

Recommendation

The office should promptly secure reimbursement from DFSC funds for payments to subrecipients.

Department of Economic Opportunity

We reviewed the Department of Economic Opportunity's (department) administration of two federal programs. They are the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 93.028 and 93.031 (formerly Federal Catalog Numbers 13.789 and 13.792).

Improper Cash Management

Finding

During fiscal year 1989-90, the department maintained balances of federal funds that exceeded its immediate cash needs in appropriations related to prior years and in appropriations related to fiscal year 1989-90. We reported a similar weakness in our audits for fiscal year 1987-88 and 1988-89. We noted the following specific incidents of improper cash management:

- During fiscal year 1989-90, the department retained excess federal funds in the state treasury for certain prior-year appropriations. Specifically, the beginning balance for these appropriations on July 1, 1989, was approximately $4.6 million. Subsequent receipts into these appropriations exceeded disbursements from these appropriations by $1.8 million, leaving a cash balance of $6.4 million on June 30, 1990. Overall, we estimate that the department's excess federal funds for certain prior year appropriations were between $4 million to $6 million during the fiscal year; and

- The department also retained excess federal funds in the state treasury for its current year local assistance appropriation. Specifically, the department requested and received $3 million in federal funds in July 1989. This amount was $1 million in excess of the department's immediate cash needs. The department maintained this excess cash from July 1989 to March 1990.

Because the department did not properly limit its request for federal funds to its immediate needs, the federal government lost interest that it could have earned on these funds. In addition, maintaining excess cash may result in the termination of advanced financing by the federal government.

The department's deputy director of administration informed us that the department will review the cash balances in the older state appropriations. The deputy director also stated that the department proposes to utilize these funds to meet its immediate obligations prior to requesting further cash from its federal funding sources.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4, requires that cash advances be limited to the actual immediate cash needed for carrying out the purpose of the program. This section also stipulates that the timing and amount of cash advances be as close as administratively feasible to the actual disbursement by the recipient organization.

Recommendation

The department should properly control its system for managing its federal funds to ensure that its requests for federal funds are limited to its immediate cash needs.

Inadequate Follow-up for Long-Outstanding Accounts Receivable

Finding

The department does not follow all of the procedures that the State Administrative Manual requires to account for and collect receivables. We noted the following exceptions in our tests of the ten largest long-outstanding accounts (over 120 days outstanding); these ten accounts total $947,000 of the department's $1.8 million long-outstanding accounts:

- The department did not provide supporting documentation for four of the ten receivables that we reviewed. Therefore, we could not determine if these four items, which totaled approximately $540,475, were valid accounts receivable; and

- The department has not taken active steps to collect long-outstanding receivables. For example, nine of the ten items we reviewed, totaling $896,784, have been outstanding from 24 to 30 months. The department did not send collection notices as a follow-up on initial billings and, consequently, the department may not be collecting all amounts owed to it. For example, one item for which there was no follow-up related to a $490,292 receivable from a non-profit corporation that subsequently filed for bankruptcy.

Criteria

The State Administrative Manual, Section 7951, states that agencies should retain detail to support general ledger account balances as of June 30. Also, the State Administrative Manual, Section 8710.1, requires each department to develop collection procedures that will ensure prompt follow-up on receivables. Finally, the State Administrative Manual, Section 8776.3, requires state agencies to prepare an invoice or other type of claim document and to send the document to the related agency as soon as possible after the recognition of a claim.

Recommendation

The department should improve its accounting for accounts receivable by providing adequate documentation. In addition, the department should develop procedures to ensure that it identifies all valid receivables and that it collects all amounts owed to it.

Fiscal Year Allotment Not Spent in Accordance With Federal Requirements

Finding

The department did not spend its fiscal year 1988-89 Community Services Block Grant (CSBG) within the same or succeeding fiscal year as required by federal regulations. Specifically, the department did not demonstrate that it spent for CSBG purposes approximately $300,000 of its $29.5 million CSBG allotment for fiscal year 1988-89.

According to the departments deputy director of administration, during the 1988-89 federal fiscal year, the department experienced a reduction in the CSBG grant award, and as a result, it practiced prudent management measures which resulted in underexpending its administrative funding by approximately $300,000. The deputy director stated that the department will request from the United States Department of Health and Human Services permission to utilize these funds for local assistance rather than returning them to the funding source.

Criteria

42 U.S. Code, Section 9907(b), requires that funds for a fiscal year appropriation be spent in the same or succeeding fiscal year.

Recommendation

The department should comply with federal regulations and spend its CSBG allotments within two fiscal years.

Department of Finance

We reviewed the Department of Finance's (department) compliance with federal and state regulations in administering the Statewide Cost Allocation Plan (SWCAP) and state regulations in administering the Prorata Allocation Plan (Prorata).

Inaccurate Workload Data Used in the SWCAP and Prorata Allocations

Finding

For the State Controller's Office, the Health Benefits for Retired Annuitants, administered by the Public Employees' Retirement System (PERS), and the department, three of the five central service agencies that we reviewed, the department made errors in calculating the workload data that it used in the SWCAP and Prorata allocations for the state agencies.

- The department incorrectly calculated the workload of the State Controller's Office. This incorrect calculation will result in overcharges of approximately $1.9 million during fiscal year 1990-91 to the PERS. Also, this overcharge to PERS will result in undercharges to federal programs for SWCAP of approximately $124,000, undercharges to all of the State's other special funds in the Prorata by approximately $595,000, and undercharges to the State's General Fund of approximately $1.2 million in the SWCAP and the Prorata. The PERS overcharge came about because the department inadvertently included in the SWCAP and Prorata workload amounts for the PERSCARE health plan (PERSCARE) in the calculation even though the State Controller's Office bills the PERS directly for these services. This was the first time that the State Controller's Office reported workload for the PERSCARE, a new health program. The department failed to recognize this change and failed to eliminate the PERSCARE workload from the total workload reported. The department's error inflated the PERS workload by 1,700 percent from the prior year's workload for PERS; and

- The department also made other errors and omissions in workload data that it used to calculate SWCAP and Prorata allocations. The department failed to obtain complete workload data for the Health Benefits for Retired Annuitants (administered by PERS) for fiscal year 1989-90. This error resulted because the department failed to request all the necessary health benefit information from the State Controller's Office.

- Further, the department made other errors in calculating the workload data for fiscal years 1988-89 and 1989-90 for its Budget Operation Support unit and for fiscal year 1989-90 for its Financial and Performance Audits unit. We observed a similar weakness during our compliance audit for fiscal year 1987-88. In March 1989, the department responded that it would revise its current procedures to ensure that the calculation of the SWCAP and the Prorata allocations use correct workload measures.

- When the department does not include all pertinent data or makes errors in its workload calculations, the allocation of SWCAP and Prorata costs to state agencies may be over or understated. It was not practical for us to determine the effect of the errors and omissions on individual agency allocations.

Criteria

The federal Office of Management and Budget, Circular A-87, states that federal programs should bear their fair share of costs recognized under Circular A-87, except where restricted or prohibited by law. The State Administrative Manual, Sections 8753 and 8755, requires the department to use actual workload measures for each department in calculating the SWCAP and Prorata allocations.

Recommendation

The department should adjust the SWCAP and Prorata allocations for the errors we identified for fiscal years 1988-89, 1989-90, and 1990-91. In addition, in its annual preparation of the SWCAP and

Prorata, the department should perform an analytical review of workload and costs reported by the central service agencies. Further, the department should request that the central service agencies explain any significant increases or decreases in the amounts they report. Finally, the department should request all the workload data that it uses in calculating the SWCAP and Prorata allocations.

Lack of Justification for SWCAP Budgets

Finding

The department's budget analysts and the state agency budget analysts are responsible for calculating the SWCAP budgets. The state agencies use the SWCAP budgets to estimate the amount to be recovered and returned to the State's General Fund from their federal programs. The department's Fiscal Systems and Consulting unit provides written instructions to its own budget analysts for calculating the SWCAP budgets. However, the department's budget analysts and the state agency budget analysts do not always follow the department's instructions for calculating the SWCAP budgets or document reasons for deviating from the recommended methodology. Attachment 3, which lists the SWCAP budgets we reviewed during fiscal years 1988-89 and 1989-90, shows the SWCAP calculations deviating from the department's recommended methodology, and identifies the agencies lacking justification for SWCAP budgets.

For fiscal year 1988-89, we recalculated the SWCAP budgets of 58 agencies using the department's recommended methodology. However, for 7 agencies, we found that the calculations deviated from the department's recommended methodology and the department could not explain why the calculations deviated. The department stated that the calculations were made in late 1987, and it could not locate documentation to support the calculations. We contacted the 7 agencies for an explanation and found that 2 agencies could explain how they calculated their SWCAP budgets and why the calculations deviated from the department's recommended methodology. However, the other 5 agencies could not satisfactorily explain their methods for calculating their SWCAP budgets. SWCAP recoveries estimated in the governor's budget for fiscal year 1988-89 for the 5 agencies are approximately $7.0 million less than they would be if the department and the state agencies had followed the department's recommended methodology. Because neither the department nor the 5 agencies could provide documentation for their calculation of the SWCAP budgets, we could not determine whether the SWCAP budgets were correct.

For fiscal year 1989-90, we also recalculated the SWCAP budgets of the 58 agencies using the department's recommended methodology. However, for 10 agencies, we found that the calculations deviated from the department's recommended methodology and the department could not explain why the calculations deviated. The department stated that the calculations were made in late 1988, and it could not locate documentation to support the calculations. We contacted the 10 agencies for an explanation and found that 2 of the 10 agencies could satisfactorily explain how they calculated their SWCAP budgets and why the calculations deviated from the department's recommended methodology. However, the other 8 agencies could not satisfactorily explain their methods for calculating their SWCAP budgets. SWCAP recoveries estimated in the governor's budget for fiscal year 1989-90 for the 8 agencies are approximately $5.8 million less than they would be if the department and the state agencies had followed the department's recommended methodology. Because neither the department nor the 8 agencies could provide documentation for calculation of the SWCAP budgets, we could not determine whether the SWCAP budgets were correct.

We reported a similar weakness in our audits for fiscal years 1986-87 and 1987-88. In January 1988 and February 1989 we recommended the following:

The departments's own budget analysts should document the methodology used to calculate the SWCAP budgets of other state agencies, and the analysts should justify any deviation from the department's recommended methodology. Also, the Fiscal Systems and Consulting unit should review the information submitted by the department's budget analysts to ensure that the amount in the governor's budget is appropriate and correctly computed.

The department responded that it would review its instructions for calculating SWCAP recoveries to determine whether changes were necessary. The department also stated, in March 1989, that it had developed a procedure for the department's budget analysts to note discrepancies between the SWCAP recovery per the department budget analyst's representation and the amount displayed in the governor's budget.

In addition, for seven agencies in fiscal year 1988-89 and two agencies in fiscal year 1989-90, the department's budget analysts reported erroneous amounts to the department's Fiscal Systems and Consulting unit. As a result the department underbudgeted SWCAP recoveries for the seven agencies in fiscal year 1988-89 by approximately $279,000, and the department overbudgeted SWCAP recoveries for the two agencies in fiscal year 1989-90 by approximately $33,000.

Criteria

The federal Office of Management and Budget, Circular A-87, states that federal programs should bear their fair share of costs recognized under Circular A-87, except where restricted or prohibited by law. A department memorandum, dated October 26, 1988, states that the department's budget analysts are responsible for ensuring that a fair share of SWCAP costs are budgeted, recovered, and returned to the State's General Fund from federal programs.

Recommendation

The department's budget analysts should document the methodology used to calculate the SWCAP budgets of other state agencies, and the analysts should justify any deviation from the department's recommended methodology. Also, the Fiscal Systems and Consulting unit should review the information submitted by the department's budget analysts to ensure that the amount budgeted is appropriate and correctly computed.

Minor Errors and Late Reporting

Finding

We noted that the department made other minor errors in the SWCAP and Prorata and also submitted the SWCAP for fiscal year 1988-89 to the federal government late.

- In addition to the errors that we reported in Items 1 and 2, the department made other minor errors in central service costs and workload calculations. For example, the department understated field audit central service costs of the State Controller's Office for fiscal year 1988-89. As a result of this error, the State's General Fund collected approximately $1,400 less than it should have from the federal government and approximately $5,600 less than it should have from the State's special funds. Further, the department underallocated the field audits workload of the State Controller's Office for one state agency in fiscal year 1988-89. This error resulted in the State's General Fund collecting approximately $274 less than it should have from the federal government. The department also overstated workload for the Health Benefits for Retired Annuitants of the Department of Developmental Services for fiscal year 1989-90. Because of this error, the department undercharged certain federal programs and the State's special funds. It was not practical for us to determine the effect of this error on individual agency allocations.

- The department submitted the SWCAP for fiscal year 1988-89 to the federal government almost one month late.

Criteria

The federal Office of Management and Budget, Circular A-87, states that federal programs should bear their fair share of costs recognized under Circular A-87, except where restricted or prohibited by law. The State Administrative Manual, Sections 8753 and 8755, requires the department to use actual workload measures for each department in calculating the SWCAP and Prorata allocations. The State Administrative Manual, Section 8752, requires state agencies to recover full costs for goods or services to other state agencies.

The federal government's "Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates for Grants and Contracts With the Federal Government" (OASC-10) requires that state cost allocation plans must be submitted to the federal government within six months after the last day of the State's fiscal year.

Recommendation

The department should improve its compliance with each of the federal and state requirements.

Health and Welfare

Department of Aging

We reviewed the Department of Aging's (department) administration of three federal programs. These programs are the U.S. Department of Agriculture grant, Federal Catalog Number 10.550, and the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 93.633 and 93.635 (formerly Federal Catalog Numbers 13.633 and 13.635).

Insufficient Monitoring of the Area Agencies on Aging

Finding

The department did not conduct performance evaluations of all the area agencies on aging. Specifically, the department did not conduct annual on-site performance evaluations of the supportive services of 3 of the 33 area agencies during fiscal year 1989-90. Furthermore, during fiscal year 1989-90, the department did not conduct on-site biennial performance evaluations of the nutrition services of 12 of the 33 area agencies. It has not conducted these biennial evaluations for 7 of the area agencies for at least three years. Failure to conduct these evaluations may prevent early detection and correction of irregularities or deficiencies in the services that the area agencies provide.

Criteria

The Code of Federal Regulations, Title 45, Section 1321.11(a) and (b), requires the department to develop policies for monitoring the performance of programs and activities initiated to provide supportive and nutrition services under Title III of the Older Americans Act. The department's Title III Program Manual, Part D, paragraph 45.1(g), requires the department to conduct on-site performance evaluations of the supportive services of the area agencies annually. Additionally, the chief of the department's Program Services Branch interprets paragraph 45.1(g) to mean that on-site evaluations of the nutrition services of area agencies be conducted at least every two years.

Recommendation

The department should conduct on-site evaluations of the supportive services of all area agencies annually and on-site evaluations of the nutrition services of all area agencies at least every two years.

Late Submission of Plan of Financial Adjustments

Finding and Criteria

The department did not submit monthly Plans of Financial Adjustment (PFA) to the State Controller's Office every month. The State Administrative Manual, Section 8452.1, requires the department to submit PFAs to the State Controller's Office monthly. We observed a similar weakness in fiscal year 1988-89.

Although this instance of noncompliance may not appear significant, it is a deviation from the State's system of internal controls, which are designed to ensure that the public's resources are not vulnerable to abuse.

Recommendation

The department should improve its compliance with state requirements.

Department of Alcohol and Drug Programs

We reviewed the Department of Alcohol and Drug Programs' (department) administration of two federal programs. These programs are the U.S. Department of Education grant, Federal Catalog Number 84.186 and the U.S. Department of Health and Human Services grant, Federal Catalog Number 93.992 (formerly Federal Catalog Number 13.992).

Lack of Independent Peer Reviews of Providers

Finding

The department does not provide independent peer reviews of many providers of alcohol and drug treatment services that receive federal funds from the Alcohol and Drug Abuse and Mental Health Services (ADAMHS) block grant. The purpose of an independent peer review is to assess the quality and appropriateness of treatment services provided by entities that received funds from the ADAMHS block grant. We found that for 30 of the 75 providers of alcohol and drug treatment services that we audited, the department did not perform independent peer reviews. As a result, the department may be jeopardizing its receipt of ADAMHS grant funds.

Criteria

42 United States Code, Section 300x-4(c)(5), requires the department to provide periodic independent peer reviews to assess the quality and appropriateness of treatment services provided by entities that receive funds from the Alcohol and Drug Abuse and Mental Health Services block grant.

Recommendation

The department should develop and implement procedures necessary to provide periodic independent peer reviews of providers of alcohol and drug treatment services.

Lack of Procedures To Monitor the Drug-Free Schools and Communities Act of 1986

Finding

The department does not have procedures to properly monitor the subrecipients of the Drug-Free Schools and Communities Act of 1986 (DFSC). The department's subrecipients include counties, nonprofit organizations, and state agencies. In our review of one of the state agency subrecipients, the Office of Criminal Justice Planning, we found that the Office of Criminal Justice Planning did not require its subrecipients under the DFSC program to provide specific information on how the high-risk youth population would be targeted and how they would ensure that not less than 90 percent of high-risk youth will participate in the program. In addition, the contracts that the Office of Criminal Justice Planning has with its subrecipients do not include a provision to notify private nonprofit schools of the DFSC services available to children and teachers of private schools. Although these requirements are provided in the department's interagency agreement with the Office of Criminal Justice Planning for fiscal year 1989-90, the department did not perform program reviews to ensure that the Office of Criminal Justice Planning complied with the federal regulations. Because the department lacks procedures to properly monitor the Drug-Free Schools and Communities Act of 1986, the State may not be able to assess progress of the program, achievement of objectives, and proper use of funds.

Criteria

The Code of Federal Regulations, Title 34, Subtitle A, Section 80.40, requires recipients of federal grants to monitor grant-supported activities to ensure compliance with applicable federal requirements. Grantees must also ensure that performance goals are being achieved. In addition, the United States Code, Title 20, Section 3192(b)(1), requires the State to spend not less than 50 percent of the Drug-Free Schools and Communities Act of 1986 grant on community-based programs designed for high-risk youth. Further, the United States Code, Title 20, Section 3192(b)(3), requires the State to ensure that not less than 90 percent of the participants in the program be high-risk youths. Finally, the United States Code, Title 20, Section 3223, requires the State to make provisions to include services and arrangements for the benefit of children and teachers of private, nonprofit schools to ensure equitable participation.

Recommendation

The department should implement procedures to monitor grant activities of subrecipients to ensure that they comply with all applicable federal requirements.

Delays in Obtaining Federal Monies for the Drug-Free Schools and Communities Grant Act of 1986

Finding

The department does not obtain federal monies for the Drug-Free Schools and Communities Act of 1986 (DFSC) grant as soon as federal regulations allow. Federal regulations allow the department to receive cash advances to administer the DFSC grant. However, we found that the department did not request cash advances to pay one of its subrecipients during fiscal year 1989-90. The department used its general fund monies to reimburse one of the department's subrecipients, the state Office of Criminal Justice Planning. The department obtained reimbursements of approximately $1.7 million of federal DFSC grant expenditures an average of 140 days after the department made the expenditures from its general fund. As a result, the State lost approximately $56,000 in interest earnings.

Criteria

The Code of Federal Regulations, Title 34, Subpart C, Section 80.21(c), allows the department to receive cash advances for the Drug-Free Schools and Communities Act of 1986, provided that the department maintain procedures to minimize the time between the department's receipt of funds and the department's transfer of the funds to subrecipients.

Recommendation

The department should promptly request federal funds that the department immediately needs.

Unauthorized Payments to Subrecipients

Finding

The department did not properly authorize some payments to subrecipients of the Alcohol and Drug Abuse and Mental Health Services block grant and the Drug-Free Schools and Communities grant. Of the 15 cash advances we reviewed, we found that 5 counties and one nonprofit organization received funds even though they did not submit required reports or documents to the department. Specifically, the department made cash advances to the counties of Santa Barbara and Nevada for the months of November and September 1989, respectively, even though the counties did not submit county plans for alcohol and drug programs that the county board of supervisors had approved. In addition, the department paid Merced County in February 1990 and Butte County in December 1989 without a contract. The department did not approve either contract until May 1990. Further, the department paid Solano County in November 1989 without the county's final cost report. The department did not receive the Solano County final cost report until December 27, 1989. Finally, the department paid one of its contractors even though it had not received the contractor's quarterly reports. The contract requires the contractor to submit quarterly reports before the department reimburses the contractor. If proper authorization is not obtained, the department is not always assured that payments to counties and nonprofit organizations are appropriate.

Criteria

The California Health and Safety Code, Sections 11815 and 11983.1, requires the board of supervisors of each county that chooses to apply for funds to submit a program plan to the department. The approved program plan will remain in effect to provide the basis for advance payment until the next year's plan is due. Further, the California Health and Safety Code, Sections 11817.1(f) and 11991.6(g), authorizes the department to deny or withhold payments or advances of funds to counties if the counties do not comply with the provisions of Sections 11815 and 11983.1. In addition, the department's contracts with counties and organizations state that the department will pay organizations only upon reciept of quarterly written progress reports.

Recommendation

The department should ensure that all its payments are properly authorized before it pays counties and organizations.

Lack of Procedures To Monitor Cash Balances

Finding

The department lacks procedures to monitor cash balances of counties for Alcohol and Drug Abuse and Mental Health Services (ADAMHS) block grants and for Drug-Free Schools and Communities Act of 1986 (DFSC) grants. The department does not require counties to adequately report the amount of federal funds they have received and the amount they have spent on ADAMHS and DFSC grants. Instead, the department makes monthly advances to counties equal to one-twelfth of the budget for each grant. At the end of the fiscal year, the department requires each county to submit an annual report of expenditures. Then the department reconciles these reports with cash advances. This procedure does not allow the department to determine if the monthly cash advances were limited to minimum and immediate needs of the counties. Consequently, the State may be advancing federal funds to counties before the counties need the monies, resulting in loss of interest earnings to the State or federal government. Additionally, the counties may be using nonfederal monies to initially finance federal grant programs, resulting in loss of interest earnings to counties. Failure to limit cash advances to minimum and immediate needs could jeopardize future advances of federal ADAMHS and DFSC grant funds.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), requires that cash advances to a primary recipient organization be limited to the minimum amounts needed and shall be timed to be in accord with only the actual, immediate cash requirements of the recipient organization. The timing and amount of cash advances must be as close as is administratively feasible to the actual disbursements by the recipient organization for direct program costs and the proportionate share of any allowable indirect costs. The Code of Federal Regulations, Title 31, Section 205.4(e), requires that advances by primary recipients to secondary recipients conform substantially to these same standards of timing and amount.

Recommendation

The department should establish procedures to monitor the cash balances of secondary recipients for ADAMHS and DFSC grants. These procedures should ensure that the department's cash advances are as close as is administratively feasible to the secondary recipients' actual disbursements and the secondary recipients' proportionate share of any allowable indirect costs.

Lack of Procedures To Identify Program and Administrative Costs

Finding

The department does not have procedures to identify whether charges to the Drug-Free Schools and Communities Act of 1986 (DFSC) grant were for administrative costs or program costs. During fiscal year 1989-90, the department classified all charges to the DFSC grant as program costs. Federal regulations for the DFSC grant allow the department to charge administrative costs of not more than 2.5 percent of the grant. Because the department does not analyze costs charged to the DFSC grant, the department may be charging the federal grant more than the 2.5 percent limit for administrative costs.

The U.S. Department of Education, in its review of the State's Drug-Free Schools and Communities Act of 1986 grant in August 1989, recommended that the department maintain appropriate records that would identify costs of administration and costs of the program. The department responded that because the DFSC-funded staff is not working on more than one cost objective, time distribution records are not necessary. However, the U.S. Department of Education, in its memo of August 29, 1989, clarified its position that appropriate records must be kept to differentiate between funds used for program costs and funds used for administrative costs.

Criteria

The United States Code, Title 20, Section 3191(a), states that the department may not charge to federal grants administrative costs of more than 2.5 percent.

Recommendation

The department should implement procedures to identify administrative costs to ensure that it does not charge more than 2.5 percent of the DFSC grant for administration.

Federal Financial Report Not Reconciled With Accounting Records

Finding

The department's Federal Cash Transactions Report (272A) for its Drug-Free Schools and Communities Act of 1986 grant for fiscal year ended June 30, 1990, contains information that does not reconcile with the department's accounting records and may be inaccurate. Specifically, for the 1987 and 1988 federal fiscal years, the department reported approximately $1.5 million and $47,000 more in DFSC grant expenditures in its federal cash transactions report than it recorded in its accounting records. In addition, for the 1989 federal fiscal year, the department reported no DFSC grant expenditures on its federal cash transactions report while reporting approximately $1.6 million in DFSC grant expenditures in its accounting records. Because the department's federal cash transactions report did not reconcile with the accounting records, we could not determine if the reports or the accounting records, or both, were inaccurate.

Criteria

The Code of Federal Regulations, Title 34, Subtitle A, Section 80.20, requires the State to maintain fiscal control and accounting procedures to permit preparation of reports required by the grant.

Recommendation

The department should implement fiscal control and accounting procedures to reconcile federal reports with its accounting records.

Employment Development Department

We reviewed the financial operations and internal controls of the Employment Development Department (department) and the department's administration of four federal programs. These programs are the U.S. Department of Labor grants, Federal Catalog Numbers 17.207, 17.225, 17.246, and 17.250.

Incorrect Assessment of Penalty and Interest on Late Tax Remittances

Finding

The department did not correctly assess penalties and interest on 7 of the 45 late tax remittances that we tested. Specifically, the department underassessed penalties and interest on 4 late tax remittances and overassessed interest on 3 late tax remittances. Although the dollar amounts of the errors in the sample were not significant, the frequency of error indicates weak internal controls. Four of the errors occurred because the cashiering group incorrectly entered the postmark date of the remittances, two of the errors occurred because the department had not yet corrected previously identified programming deficiencies in its Tax Accounting System (TAS), and one of the errors probably occurred because the cashiering group did not make the mark on the tax return dark enough to be read by the Optical Character Recognition (OCR) equipment.

Criteria

The California Unemployment Insurance Code (CUIC), Sections 1126 and 1127, requires the department to assess a 10 percent penalty on late or unsatisfactory tax remittances. In addition, the CUIC, Section 1113, states that employers are liable for interest on late tax remittances from the date of delinquency until the date paid.

Recommendation

The department should continue to remind the cashiering group staff that it is important to enter the postmark date on the tax forms correctly and that they should make any marks on the tax forms dark enough to be read by the OCR equipment. Also, the department should ensure that programming deficiencies in its TAS are corrected as soon as possible.

Misstatement of Account Balances

Finding

The department made clerical errors when it posted data from supporting documents to the automated system that is used as a subsidiary ledger. The ledger is used to record amounts that the department owes to subgrantees and that subgrantees owe to the department for the Job Training Partnership Act (JTPA) program. For example, the department posted prepayments to subgrantees and receipts from subgrantees to incorrect contract numbers and program codes. If the individual contract or program balances are incorrect, subsequent postings of expenditures result in overstatements of prepayments and accounts payable to some subgrantees.

Based on a sample of approximately 68 percent of the prepayment balance, we determined that the department overstated prepayments and accounts payable to subgrantees at June 30, 1990, by at least $3.8 million. The department subsequently identified all of the errors and concluded that the total overstatement was approximately $5.0 million. Even though the overstatement of the prepayments and accounts payable to subgrantees did not affect the department's fund balance on its financial statements, failure to report these accounts accurately to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately.

Criteria

The California Government Code, Sections 13401(b)(1) and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control, including a system of recordkeeping procedures, is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation

The department should develop a system of reconciliation and review to ensure that the supporting data is accurately posted to the subsidiary ledger for prepayments and accounts payable to subgrantees for the JTPA program.

Late Resolution of Audit Reports

Finding

In fiscal year 1989-90, the department did not resolve questioned costs in 9 of 64 audit reports for subgrantees of the JTPA program within the required six months of the subgrantees' receipt of the final audit report. Failure to resolve questioned costs can result in additional questioned costs if the subgrantees do not correct deficiencies in their internal controls within a reasonable time.

We reported a similar weakness during our financial audits for the five previous fiscal years. The department established a unit within its Job Training Partnership Division to resolve the questioned costs in the audit reports for the subgrantees of the JTPA program. Since the establishment of this unit, the number of audit reports that were resolved late has decreased. The department reported that, as of December 31, 1990, it had resolved all questioned costs identified in audit reports in fiscal year 1989-90.

Criteria

The Office of Management and Budget, Circular A-128, requires the department to ensure that subgrantees take appropriate corrective action within six months after the subgrantees receive their audit reports.

Recommendation

The department should continue its efforts to reduce delays in the resolution of audits so it can resolve questioned costs in all subgrantees' audit reports within six months after the subgrantees receive the reports.

Late Federal Financial Reports

Finding

The department did not submit its monthly Unemployment Insurance Financial Transaction Summary reports to the federal government within ten business days, as required, for any of the months of fiscal year 1989-90. The department submitted the reports as late as 47 business days after the deadlines. In addition, the department did not submit its quarterly reports showing the expenditures and financial condition of federal funds for unemployment compensation for federal employees and ex-service members within 25 days, as required, for any of the quarters during fiscal year 1989-90. The department submitted the reports as late as 133 days, or more than four months, after the deadline. The department stated that it cannot promptly submit the reports because it cannot summarize the information within the required time. Failure to promptly submit these reports may place the department in jeopardy of fiscal sanctions imposed by the federal government.

We reported a similar weakness during our financial audits for the six previous fiscal years. The department reports that, once it has fully implemented the single client data base, it will be able to submit the reports within the required time. The department now expects to fully implement this system by June 1992.

Criteria

The Employment Security Manual, Part V, Section 9320, requires the department to submit the Unemployment Insurance Financial Transaction Summary report within ten business days after the end of each month. In addition, the Employment Security Manual, Part V, Section 9336, requires the department to submit the report showing the expenditures and financial condition of federal funds for unemployment compensation for federal employees and ex-servicemembers by the 25th day after the end of each quarter.

Recommendation

The department should continue to automate its accounting systems so it can submit reports within the required time.

Noncompliance With Federal, State, and Departmental Requirements

Findings and Criteria

In the following instances, the department did not always comply with administrative requirements of the federal government, the State, or the department:

- The department made a clerical error when preparing the Unemployment Insurance Financial Transaction Summary report for May 1990. As a result, the department overstated the federal share of expenditures on the report by approximately $37,000. After we notified the department of the error, it subsequently corrected this error in its November 1990 report. The Employment Security Manual, Part V, Section 9325, requires that the department's accounting records support this report.

- One of the 77 disability insurance claim forms we reviewed did not include the signature of a licensed physician. The Unemployment Insurance Code, Section 2708, requires the claims for disability benefits to be supported by the signed certificate of a licensed physician or other licensed medical professionals.

- Two of the department's disability field offices were unable to provide us with the initial claim forms for 3 of the 77 disability benefit payments we tested. The California Government Code, Sections 13401(b)(1) and 13403, requires agencies to ensure that a satisfactory system of internal accounting and administrative control, including a system of recordkeeping procedures, is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures.

- Three of the 77 continued unemployment insurance claim forms we reviewed were signed and dated by the claimants before the end of the period for which they were claiming benefits. Further, two more of these claim forms were not dated by the claimants when they signed the forms. The department's continued Claims Manual, Section CT 1705, formerly CT 1709, requires claim processors to return to claimants all claims that are signed before the end of the period for which the claims are being made. Also, the policy requires claim processors to return to claimants undated claims unless the postmark date on the envelope is after the last day of the week being claimed.

Although individually these instances of noncompliance may appear to be insignificant, any deviation from the State's system of internal controls and any violation of federal regulations exposes the public's resources to abuse.

Recommendation

The department should improve its compliance with each of the federal, state, and departmental requirements.

Health and Welfare Agency Data Center

We reviewed the financial operations and related internal controls at the Health and Welfare Agency Data Center (data center).

Possible Liability to the Federal Government

Finding

The data center provides data processing services, procures electronic data processing equipment, and provides related training services to state agencies. During fiscal years 1984-85 through 1988-89, the data center charged state agencies for more than the costs it incurred. State agencies, in turn, allocated a share of the data center's billings to federal programs. Thus, the federal programs absorbed a portion of the excess charges, which is a violation of federal regulations. Consequently, the data center may have a liability to the federal government of approximately $7.3 million for profits it accumulated in its revolving fund from July 1, 1984, through June 30, 1990. The amount represents approximately 37 percent of the data center's profits accumulated over the six-year period. If proposed changes in federal regulations are adopted retroactively, the possible liability would be substantially reduced.

The data center is able to overbill state agencies because, in part, the Department of Finance has not developed accounting procedures that ensure that the data center does not charge federal programs, through the state agencies, for more than its costs. When we reported a similar finding during our financial audit for fiscal year 1988-89, the Director of Finance responded that he planned to address the issue of setting rates for internal service funds once the Office of Management and Budget decides on the proposed amendments to Circular A-87, "Cost Principles for State and Local Governments."

In last year's audit for fiscal year 1988-89, our estimate of the potential liability for the period July 1, 1984, through June 30, 1989, was approximately $12 million, based on a federal share of accumulated profits of 58 percent rather than 37 percent of accumulated profits. The 58 percent represented the percentage used in the previous settlement between the State and the federal government on the same issue for the years from 1969 to 1984. The decline in the federal share of accumulated profits from 58 percent to 37 percent accounts for substantially all of the decrease in the potential liability from $12 million to $7.3 million. This year's estimate of the federal share of accumulated profits was made by officials of the data center. We did not verify the accuracy of that estimate. The officials of the data center contend that, because its newer customers have a lower federal funding ratio, the relative share of the data center's services for federal programs has decreased since 1984, resulting in a smaller percentage of federal participation.

Criteria

The California Government Code, Section 13070, provides the Department of Finance with general powers of supervision over all matters concerning the financial and business policies of the State. The California Government Code, Section 11755, allows the data center to accumulate profits in its revolving fund up to certain limits. However, the federal Office of Management and Budget, Circular A-87, "Cost Principles for State and Local Governments," prohibits the State from charging federal programs for amounts that exceed costs. Proposed amendments to Circular A-87 would allow the State to retain a reasonable working capital reserve of up to 60 days' cash expenditures, excluding the costs for capital items.

Recommendation

The data center and the Department of Finance should develop accounting procedures that ensure that the State complies with federal regulations. This could be done by developing billing rates that reflect only costs or by developing two billing rates, one that can be charged to state programs and another that can be charged to federal programs. In addition, the data center and the

Department of Finance should monitor the approval of the proposed amendments to Circular A-87 and should determine the effect the revisions may have on the State's charges to federal programs.

Lack of Reconciliation of Account Balances

Finding

The data center did not reconcile some general ledger control accounts with their detail support. Specifically, the data center did not reconcile its detail listing of installment contracts payable with the balance in the general ledger control account. We noted an unidentified difference of $583,596 as of June 30, 1990. In addition, the data center did not reconcile its detail listing of accounts receivable with the general ledger control account although the difference was relatively small. As a result of not reconciling its account balances, the data center cannot be assured that the amounts recorded in the general ledger are correct. We reported a similar weakness in our audit for fiscal year 1988-89.

Criteria

The State Administrative Manual, Section 7900, stresses the importance of monthly reconciliations. Reconciliations are an important internal control because they provide additional assurance that transactions have been correctly recorded and that the financial statements are complete.

Recommendation

The data center should follow the procedures outlined in the State Administrative Manual.

Department of Health Services

We reviewed the financial operations and related internal controls of the Department of Health Services (department) and the department's administration of four federal programs. These programs are the U.S. Department of Agriculture grant, Federal Catalog Number 10.557 and the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 93.026, 93.778, and 93.994 (formerly Federal Catalog Numbers 13.787, 13.714, and 13.994).

Food Vouchers Not Reconciled Promptly

Finding

For each month of fiscal year 1989-90, the department was late in completely reconciling the food vouchers it issued with the food vouchers redeemed by participants in the federal Special Supplemental Food Program for Women, Infants, and Children (WIC). Specifically, the department did not complete the reconciliations within 150 days of the first day of authorized use. Failure to promptly reconcile the vouchers may delay detection of irregularities such as the redemption of fraudulent food vouchers.

According to the department, problems with its voucher monitoring system, which uses optical character recognition equipment to process issuance documents for reconciliation with redeemed vouchers, contributed to the delays in completing monthly reconciliations. For fiscal year 1989-90, the department was unable to promptly prepare its computer file of food vouchers issued to match with the computer file of food vouchers redeemed. Consequently, the department was unable to provide the information necessary to promptly prepare the monthly reconciliations.

We reported a similar weakness during our audits for fiscal years 1987-88 and 1988-89. In March 1990, the department stated that it had completed negotiations with its contractor to modify the optical character recognition system to address the problems.

Criteria

The Code of Federal Regulations, Title 7, Section 246.12(n)(1), requires the department to reconcile the food vouchers it issued with the food vouchers redeemed by participants within 150 days of the first date of authorized use.

Recommendation

The department should ensure that it reconciles food vouchers issued with food vouchers redeemed within 150 days of the vouchers' issue date.

Suspension of Procedures for Detecting and Resolving Dual Enrollment

Finding

In July 1987, the department suspended its procedures for detecting dual enrollment in WIC because the procedures did not operate as intended and produced inaccurate reports. These reports were intended to detect WIC participants who may have enrolled at more than one location. The department's failure to produce accurate reports reduced its ability to detect and resolve participant abuses.

We reported a similar weakness in our audits for fiscal years 1987-88 and 1988-89. In March 1990, the department stated that the department and its contractor, the Department of General Services, had resolved the problem with reporting procedures and that a revised report would be in production by March 30, 1990. However, the first usable revised report was not produced until December 1990. The department is now implementing procedures to resolve the reported instances of suspected dual enrollment.

Criteria

The Code of Federal Regulations, Title 7, Section 246.7(k), requires the department to detect instances of dual participation.

Recommendation

The department should continue its efforts to establish reliable procedures to detect instances of dual participation.

Lack of Site Reviews

Finding

For 5 of the 8 local agency reviews we chose to examine for fiscal year 1989-90, the department did not conduct required annual site reviews for the administration of WIC. Without such site visits, which include reviews to determine whether the local agencies provide appropriate health services and nutrition education and whether they employ a prescribed food delivery system, the department lacks assurance that the local agencies are complying with requirements of the federal program.

During our audit for fiscal year 1988-89, we reported that the department did not have documentation for two of the eight site reviews that we selected to review. In March 1990, the department stated that, although the documentation of the site reviews was not available by the end of our audit work for fiscal year 1988-89, the documentation was subsequently available. However, when we requested the documentation for the site reviews, the documentation was still not available for one site and was incomplete for the other.

Criteria

Title 7 of the Code of Federal Regulations, Section 246.6(b), states that local agencies providing WIC services should meet specific requirements in dispensing services to beneficiaries. As part of the department's procedures to ensure that local agencies meet these requirements, the California State Plan for Operation of the Special Supplemental Food Program for Women, Infants, and Children requires the department to conduct an annual site review at each local agency.

Recommendation

The department should complete required site reviews of local agencies and should maintain adequate documentation of these reviews.

Delays in Requesting Reimbursements From the Federal Government

Finding

The department did not promptly request reimbursement from the federal government for costs it incurred for the administration of four federal grants. Because state money was used to fund these costs before the department requested and received federal reimbursements, the state money was not available to earn interest. As a result, we estimate that the State lost approximately $645,500 in potential interest earnings. We found the following specific conditions:

- From November 1989 through April 1990, the department rarely had federal money available from WIC to fund costs as they were incurred. Based on our analysis of the disbursements and reimbursements for the grant during this period, we estimate that the State lost potential interest earnings of approximately $175,000 during fiscal year 1989-90.

- For the 55 disbursements for the Maternal and Child Health Services Block Grant we tested in fiscal year 1989-90, the department delayed requesting reimbursements for periods ranging from 14 to 160 days. Based on our analysis of these disbursements and reimbursements, we estimate that the State lost potential interest earnings of approximately $234,500 during fiscal year 1989-90.

- For the 30 disbursements we tested for the State Legalization Impact Assistance Grants, the department delayed requesting reimbursements for periods ranging from 4 to 134 days. These disbursements were initially processed through procedures for the Medical Assistance Program. Based on our analysis of these disbursements and reimbursements, we estimate that the State lost potential interest earnings of approximately $135,500 for the grant during fiscal year 1989-90.

- For the 26 disbursements we tested for the Refugee and Entrant Assistance--State Administered Programs grant, the department delayed requesting reimbursements for periods ranging from 32 to 138 days. Based on our analysis of these disbursements and reimbursements, we estimate that the State lost potential interest earnings of approximately $100,500 for the grant during fiscal year 1989-90.

Criteria

The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from federal grant funds for goods and services provided.

Recommendation

The department should promptly request reimbursement from the federal government for costs incurred for administering federal programs.

Lack of Audits of Nonprofit Subrecipients of Some Federal Grants

Finding

The department did not ensure the performance of biennial audits of nonprofit subrecipients of three federal grants. Specifically, the department did not ensure the performance of required biennial audits for 65 of the 79 nonprofit subrecipients of the Maternal and Child Health Services Block Grant or for the 12 nonprofit subrecipients of the Preventive Health and Health Services Block Grant. In addition, the department did not prepare an annual audit plan for these federally funded block grant programs to submit to the State Controller's Office for fiscal years 1988-89 and 1989-90. The department also did not ensure the performance of required audits for 1 nonprofit subrecipient of the Childhood Immunization Grants. Without these audits, the department lacks assurance that nonprofit subrecipients are complying with federal laws and regulations.

Criteria

The federal Office of Management and Budget (OMB) Circular A-110, which describes audit requirements for nonprofit entities, requires the State to ensure that its nonprofit subrecipients receive these audits at least every two years. For fiscal years beginning on or after January 1, 1990, OMB Circular A-133, which also requires biennial audits of nonprofit subrecipients, supersedes the audit requirements of Circular A-110. The Government Code, Section 53134, also requires that subrecipients receiving funding from federal block grants be audited not less frequently than every two years. In addition, the Government Code, Section 53135, requires that state agencies administering federal block grants prepare an annual audit plan.

Recommendation

The department should ensure that nonprofit subrecipients are audited at least once every two years and should prepare its audit plan annually.

Delay in Implementing a Cost Avoidance System

Finding

The department has not fully implemented a cost avoidance system to avoid paying Medi-Cal claims for beneficiaries who have other health care coverage. As a result, the department continues to pay some claims for which third parties, such as insurance companies, are liable.

Since May 1986, federal regulations required the department to use a cost avoidance system to reject and return to health care providers claims for which third parties are probably liable. If any third parties are liable, the department must return the claim to the provider and instruct the provider to collect from third parties first. The department can then pay the balance up to the maximum amount allowed.

In response to the federal requirements, the department developed a three-phase plan to implement a cost avoidance system. By the end of the second phase, the system was able to identify beneficiaries with health plans that provided full coverage. The department is currently implementing the third phase, which will identify beneficiaries whose health plans provide partial coverage. According to the status report for October through December 1990 that the department submitted to the federal Health Care Financing

Administration, the department expects to complete the third phase in March 1991. The department provides a quarterly status report on its progress to the federal Health Care Financing Administration.

Until the third phase is complete, the department will continue to pay some claims for which third parties may be liable. For example, 3 of the 96 claims that we examined involved Medi-Cal services to beneficiaries who had other health care coverage. In each of the 3 cases, the department paid the claims before it identified the third parties.

We reported a similar weakness during our audits for fiscal years 1986-87 through 1988-89.

Criteria

The Code of Federal Regulations, Title 42, Section 433.139, required the department to implement by May 12, 1986, a cost avoidance system to reject and return to providers claims for which third parties are probably liable unless the department received approval for a waiver from this requirement. Under this cost avoidance system, the providers must determine third party liability first, then determine the unpaid amount, if any, and submit these claims to the department for payment.

Recommendation

The department should continue its efforts to fully implement its cost avoidance system for Medi-Cal payments and should continue to inform the federal Health Care Financing Administration of its progress.

Inaccurate Estimates of Receivables

Finding

The department did not follow state procedures in estimating receivables reported to the State Controller's Office for inclusion in the State's financial statements. The department estimated certain receivables owed to the Health Care Deposit Fund at June 30, 1990, to be approximately $297 million. However, the department included in its estimate all receivables that it expected to collect rather than only those receivables that it expected to collect in the ensuing 12 months. The State Controller's Office reports receivables that are expected to be collected in the ensuing 12 months. As a result, the amount of receivables that the department reported to the State Controller's Office as of June 30, 1990, was higher than it should have been. Our estimate of receivables the department would collect in the ensuing 12 months is approximately $84 million, $213 million less than the $297 million that the department estimated.

We reported a similar weakness during our audits for fiscal years 1987-88 and 1988-89. In March 1990, the department stated that it was accumulating data about collections on accounts receivable to provide an accurate estimate of receivables. The department estimated that the data base would be available for the end of fiscal year 1989-90.

Criteria

The State Administrative Manual, Section 7620, requires the department to record receivables that it does not expect to collect within one year in a deferred account for financial statement purposes. Recording the receivables it does not expect to collect in one year in this deferred account enables the department to report as the net amount for accounts receivable only the receivables expected to be collected within one year.

Recommendation

The department should develop a system that allows the department to estimate and report at the end of the fiscal year only those receivables it expects to collect in the ensuing 12 months.

Federal Reimbursements Not Identified and Requested

Finding

The department did not identify and request reimbursements from the federal government for certain federally reimbursable costs incurred under the Child Health and Disability Prevention (CHDP) Branch. Counties under contract with the department provide CHDP services and bill the department for repayment. The federal government will reimburse the department for certain costs that county CHDP staff incur in serving children eligible for Medi-Cal. However, because the counties participating in the CHDP program during fiscal year 1989-90 did not provide sufficient information to allow the department to identify costs that were federally reimbursable and the department did not have an alternative system in place to identify these costs, the department did not request the reimbursements.

We reported a similar weakness during our audit for fiscal year 1988-89, when the department had not claimed federal reimbursements for costs for fiscal years 1987-88 and 1988-89. In March, the department stated that it had identified and claimed the amounts for both fiscal years. However, we determined that the department had claimed the amount for fiscal year 1988-89, totaling approximately $39,000, but had not yet claimed the amount for fiscal year 1987-88 or identified and claimed the amount for fiscal year 1989-90. The department also stated that it was developing an automated system to identify and report federally reimbursable expenditures based on data obtained from contracted counties. The department expected this automated system to be operable in the 1990-91 fiscal year. As of September 1990, the department had not implemented such a system.

Criteria

The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from federal grant funds for goods and services provided.

Recommendation

The department should continue its efforts to establish a system to identify federally reimbursable costs that the counties incur and should promptly request the federal reimbursements.

Errors in Reimbursements to the General Fund

Finding

The department made several clerical errors during fiscal year 1989-90 in calculating reimbursements to the General Fund for costs incurred on behalf of other funds. Specifically, the department reimbursed the General Fund from the Genetic Disease Testing Fund by approximately $194,000 less than it should have and reimbursed the General Fund from the State Vital Record Improvement Project Fund by approximately $18,000 less. As of January 25, 1991, the department had not yet begun reimbursing the General Fund for these amounts.

Criteria

The State Administrative Manual, Section 6131, indicates that reimbursements are repayments for the cost of work or services performed and that a positive, direct relationship should exist between the cost of the particular services and the reimbursement.

Recommendation

The department should ensure that it calculates the reimbursements to the General Fund correctly.

Erroneous Report of Uncleared Collections in the Other Health Coverage Unit

Finding

The department's other health coverage unit in the Recovery Branch did not maintain a reliable quarterly Report of Uncleared Collections, which the department uses to match and clear accounts receivable with amounts collected. For example, most of the entries in the June 30, 1990, quarterly report represented errors, duplications, and items that the department had already cleared. As a result, the department wasted staff time by correcting errors and duplicating its prior efforts.

According to the unit chief, the department has not been able to correct the causes of the errors on the report and will use an entirely new system for matching collections with accounts receivable once the department fully implements the cost avoidance system discussed above.

Criteria

The California Government Code, Section 13402, requires the department to establish and maintain a system of internal accounting control and ensure that the system is functioning as prescribed. In addition, Section 13401 (b)(2), requires the department to promptly correct weaknesses in its system of internal control when detected.

Recommendation

The department's other health coverage unit in the Recovery Branch should maintain a reliable Report of Uncleared Collections.

Inaccurate Identification of Encumbrances

Finding

The department did not accurately analyze its listing of payables to determine which items represented encumbrances in 5 of the 6 departmental funds for which we reviewed encumbrances. Under generally accepted accounting principles, encumbrances are amounts committed for goods or services to be received after the end of the fiscal year. As a result of its inaccurate analysis of payables as of June 30, 1990, the department incorrectly reported encumbrances to the State Controller's Office. For example, the department reported approximately $31.7 million in encumbrances for the General Fund and reported no encumbrances for the Federal Trust Fund. However, we determined that the appropriate encumbrance amounts were approximately $14.2 million and $5.3 million, respectively. If the department does not properly identify encumbrances in its financial reports, the State Controller's Office does not have appropriate information to prepare the State's financial statements in accordance with generally accepted accounting principles.

Criteria

The State Administrative Manual, Section 10544, requires agencies to analyze their encumbrances to determine which are valid as of June 30 of each fiscal year. Further, the State Controller's Office issued a memorandum, dated May 15, 1990, instructing departments to report the amount of encumbrances so that the State Controller's Office can prepare the State's financial statements in accordance with generally accepted accounting principles.

Recommendation

At the end of the fiscal year, the department should analyze its commitments to determine whether goods or services were received before June 30 or will be received after June 30 and should correctly report as encumbrances to the State Controller's Office only those amounts committed for goods or services not received by June 30.

Weaknesses in Control Over the Revolving Fund

Finding and Criteria

The department has weaknesses in its control over its revolving fund. We noted the following specific deficiencies:

- The department did not confirm with its employees its continuing travel advances made from the revolving fund and outstanding on June 30, 1990. The State Administrative Manual, Section 8116, requires the department to confirm directly with its employees the continuing travel advances outstanding at the end of the fiscal year.

- The department did not promptly claim full reimbursement from the State Controller's Office for its revolving fund. As of June 30, 1990, the department had not claimed reimbursement for approximately $12,000 in disbursements made during the 1987-88 fiscal year because it has lost the supporting documentation. The State Administrative Manual, Section 8170, provides the procedures an agency should use to prepare claim schedules to reimburse the revolving fund. Good accounting procedures require the revolving fund to be reimbursed promptly.

- Approximately $41,000 of the department's salary advances made from the revolving fund and outstanding as of June 30, 1990, were over 120 days old. As a result, the employees, rather than the State, had use of the advanced funds during this extended period. These advances were outstanding because of delays in setting up the accounts and because the department allowed some accounts to be repaid on an installment basis. The State Administrative Manual, Section 8118, requires the department to collect salary advance repayments from the subsequently issued payroll warrants for the time periods covered by the salary advances.

- The department issued duplicate payments to three vendors during 1988 and 1989 because the department erroneously directed the State Controller's Office to pay the vendors after the department had already paid the vendors from the revolving fund. As of November 1990, the department had not recovered over $10,000 of the approximately $11,000 in duplicate payments. The State Administrative Manual, Section 8422.1, specifies that invoices submitted to the State Controller's Office for payment must not have been previously paid.

Recommendation

The department should ensure its compliance with each of these required controls over the revolving fund.

Noncompliance With Certain Federal Requirements

Finding and Criteria

In the following instances, the department did not always comply with federal administrative requirements:

- Vendors did not endorse 5 of the 50 food vouchers we examined for WIC. Vendor endorsements provide the department a means of analyzing the redeemed vouchers and of identifying vendors that may not be authorized to redeem food vouchers and vendors that may not be complying with all provisions of the program. We reported a similar weakness during our audit for fiscal years 1987-88 and 1988-89. In March 1990, the department stated that it operates the voucher redemption system in accordance with federal and state administrative requirements as much as possible and that the costs of inspecting each voucher would be prohibitive. The department indicated that it reviews for potentially fraudulent vouchers from food store vendors with a high risk of fraud and for vouchers redeemed at or near the maximum value. The Code of Federal Regulations, Title 7, Section 246.12(r)(4), requires the department to identify redeemed food vouchers to specific vendors.

- In one instance, the participant in WIC did not endorse the food voucher we examined. Participant endorsements provide the department a means of identifying holders of vouchers and verifying their eligibility. Section 310-40 of the WIC program manual requires the signature of the participant or authorized alternate individual to be entered on the food voucher when redeemed.

- One voucher we examined for the WIC program was redeemed before the authorized date. In addition, departmental records indicate that for each month of fiscal year 1989-90, vouchers were redeemed before the authorized issue date. This is possible because some food vouchers can be issued two to three months in advance to qualified recipients. Early redemption of vouchers impairs the department's control over vouchers. The Code of Federal Regulations, Title 7, Sections 246.12(r)(2)(i) and (ii), requires food vouchers to be redeemed on or after the authorized date.

- During fiscal years 1988-89 and 1989-90, the department inappropriately charged a total of $1,015 for a refrigerator, a microwave oven, and a microwave cart for an eating facility at the Office of AIDS to the Acquired Immunodeficiency Syndrome (AIDS) Activity federal grant. The federal Office of Management and Budget Circular A-87 states that to be allowable under a grant program, costs must be necessary and reasonable for the proper and efficient administration of the grant program.

- The department was late in filing the biannual summary reports about the eligibility of recipients and the payments made to providers of the Medical Assistance Program. The department submitted one report to the Health Care Financing

Administration 54 days late and the other report 63 days late. The reports were due on November 30, 1989 and May 31, 1990. The Code of Federal Regulations, Title 42, Section 431.800(f)(4), establishes the proper dates for the reports to be filed.

Although individually these instances of noncompliance may not appear to be significant, they represent noncompliance with federal regulations. Federal regulations are designed to protect that the public's resources from abuse.

Recommendation

The department should improve its compliance with federal requirements.

Department of Mental Health

We reviewed the financial operations and internal controls of the Department of Mental Health (department) and the department's administration of two federal programs. These programs are the U.S. Emergency Management Agency grant, Federal Catalog Number 83.516 and the U.S. Department of Health and Human Services grant, Federal Catalog Number 93.992 (formerly Federal Catalog Number 13.992).

Lack of Policy To Complete Reviews of Performance of Secondary Recipients

Finding

The department has not established policy to define the frequency and completion dates of required performance reviews of secondary recipients. In addition, the department has not issued reports signifying completion of any performance reviews for fiscal years 1988-89 and 1989-90. The purpose of a performance review is to assess the quality and appropriateness of treatment services provided by entities that receive funds from the Alcohol and Drug Abuse and Mental Health Services (ADAMHS) federal block grant. Because the department has not assessed the quality and appropriateness of treatment services provided by entities that received funds from the ADAMHS block grant for fiscal years 1988-89 and 1989-90, it has a weakness in its system to ensure that these organizations complied with federal regulations.

The department told us that its policy is to conduct periodic assessments of various ADAMHS block grant programs on an "as needed" basis. Further, the department said that it conducted a substantive statewide review of providers that receive funds from the ADAMHS block grant during the fall 1990. The reviews involved visits by more than 30 department staff members to providers in all of the counties that receive funds from the ADAMHS block grant. However, as of December 1990, the department had not issued reports on these reviews. We reported a similar finding during our audit for fiscal year 1988-89. In its response of February 1990, the department said that the lack of performance reviews during the fiscal year 1988-89 was a temporary result of the department's internal reorganization.

Criteria

42 United States Code, Section 300X-4(c)(5), requires that the State agree to provide for periodic independent peer review to assess the quality and appropriateness of treatment services provided by entities that receive funds from the ADAMHS block grant. However, neither federal regulations nor the department have defined the frequency or completion dates for periodic reviews required by 42 United States Code, Section 300X-4(c)(5).

Recommendation

The department should establish policy and implement procedures to assess the effectiveness of secondary recipients' performance and should complete its assessment of secondary recipients' performance.

Lack of Monitoring of Secondary Recipients' Cash Balances

Finding

The department did not monitor the cash balances of secondary recipients for the Alcohol and Drug Abuse and Mental Health Services (ADAMHS) block grant during fiscal year 1989-90. As a result of this lack of monitoring, the secondary recipients may have maintained cash balances that exceeded federal limits.

We reported a similar finding during our audit for fiscal year 1988-89. In its response in February 1990, the department reported that it would implement procedures to ensure that cash balances maintained are within federal limits and that it would monitor compliance. However, the department has since informed us that it was unable to monitor the secondary recipients' cash balances for fiscal year 1989-90 because the staff person whose duties included entering data from quarterly expenditures reports was transferred. The department told us that it is currently evaluating an alternative payment system that would improve the monitoring of the secondary recipients' cash balances.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), requires that cash advances to primary recipients be limited to the minimum amounts needed and be timed to be in accord only with the actual, immediate cash requirements of the recipient in carrying out the purpose of the approved program or project. The timing and amount of cash advances must be as close as is administratively feasible to the actual disbursements by the recipient organization for direct program costs and the proportionate share of any allowable indirect costs. The Code of Federal Regulations, Title 31, Section 205.4(e), requires that advances made to secondary recipients are to conform substantially to the same standards of timing and amount as apply to federal advances to primary recipients. In our opinion, proper compliance with federal regulations requires that primary recipients monitor regularly the cash balances of secondary recipients.

Recommendation

The department should monitor the cash balances of secondary recipients to ensure that the cash balances are not in excess of federal regulations.

Weaknesses in Controls Over the Office Revolving Fund

Finding

The department has weaknesses in control over travel advances and accounting for other advances made from the office revolving fund. Specifically, we noted the following conditions:

- The department has not taken effective steps to obtain travel expense claims or collect money from its employees to clear its long-outstanding travel advances. As of June 30, 1990, $34,102 or 56 percent of the total nonpermanent travel advances were outstanding for over 60 days. Failure to reimburse the office revolving fund for travel advances may unnecessarily reduce funds available for other uses.

- The department did not maintain a listing of advances, including vendors' invoices or other documents, to support $15,920 it disbursed from its revolving fund as of June 30, 1990. As a result, the department may not be able to claim this amount from the State Controller's Office to reimburse its revolving fund. In addition, the lack of vendors' invoices or other documents can result in undetected errors and irregularities.

Criteria

The State Administrative Manual, Section 8116, requires agencies to reimburse and, therefore, clear advances from the revolving fund when employees submit their travel expense claims. If the advance exceeds an employee's travel expense claim, the employee is required to reimburse the revolving fund promptly unless it is known that the employee will travel in the near future. The State Administrative Manual, Sections 8190 and 8192, requires state agencies to maintain a listing of advances, including vendors' invoices made from the revolving fund, to account for all of the fund's transactions.

Recommendation

The department should implement procedures to obtain travel expense claims or collect long-outstanding advances from its employees. The department should also implement procedures to properly maintain a listing of advances made from the revolving fund.

Inaccurate Accounting for Liabilities of the General Fund

Finding

The department did not account for approximately $5,652,000 of its general fund liabilities at June 30, 1990. Specifically, we found that the department did not record in its general fund accounts the amount owed by the general fund to other funds. The department recorded, in its general fund, funds that belong to its Special Deposit Fund and its Cigarette and Tobacco Surtax Fund. However, as of June 30, 1990, the department did not record, as payable to these funds, approximately $3,983,000 owed by the general fund to the Special Deposit Fund and approximately $1,669,000 owed by the general fund to the Cigarette and Tobacco Surtax Fund. As a result, the department's general fund liabilities were understated by approximately $5,652,000.

If the department does not properly identify liabilities in its financial records, the State Controller's Office does not have appropriate information to prepare the State's financial statements in accordance with regulatory requirements and in accordance with generally accepted accounting principles.

Criteria

The State Administrative Manual, Section 10544, requires agencies to review their records to ensure that they have accurately identified and recorded all liabilities.

Recommendation

The department should properly analyze and record liabilities in its general fund.

Inaccurate Analysis and Reporting of Encumbrances

Finding

The department did not accurately analyze and report encumbrances at June 30, 1990. Under generally accepted accounting principles, encumbrances are commitments for goods or services to be received after June 30. For its portion of the State's General Fund, the department understated encumbrances on its memo entries on the Report of Accruals to Controller's Accounts by approximately $385,000. These misstatements occurred because the department did not thoroughly analyze its commitments and payables to determine whether it had received the goods or services before or after June 30. Failure to analyze commitments and accurately report encumbrances to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately and in accordance with generally accepted accounting principles.

We reported a similar weakness in fiscal years 1987-88 and 1988-89. In its response of February 1990, the department indicated that it had trained its staff and assigned responsibility within the accounting office to correctly identify encumbrances.

Criteria

The State Administrative Manual, Section 10544, requires agencies to analyze their commitments at June 30 and to determine whether they received the goods and services before or after June 30.

Recommendation

The department should analyze its commitments to determine whether it received the goods or services before or after June 30 and appropriately report the commitments as payables or encumbrances.

Department of Rehabilitation

We reviewed the Department of Rehabilitation's (department) administration of the U.S. Department of Education grant, Federal Catalog Number 84.126.

Use of Incorrect Indirect Cost Rate

Finding

The department did not use an agreed-upon indirect cost rate to calculate administrative expenditures charged to the federal government. During our testing of administrative expenditures included in the department's federal financial status reports, we noted that the department did not use an agreed-upon rate to complete its financial status reports for June 30, 1990. The agreed-upon rate was from an indirect cost rate agreement, dated July 13, 1990. In that proposal, the United States Department of Education and the department agreed that, effective July 13, 1990, the department would use an indirect cost rate for fiscal year 1989-90 that specifically excludes legislative costs. However, the department used an indirect cost rate that includes costs of the department's legislative unit.

In addition to including costs of the department's legislative unit in its calculation of the 1989-90 indirect cost rate, the department made several clerical errors in calculating chargeable indirect costs. The net effect of these errors is that the department's June 30, 1990, financial status reports understated expenditures reported to the federal government by approximately $800,000.

Criteria

The federal Office of Management and Budget, Circular A-87, Paragraph 830 Section J(1), requires a plan for the allocation of costs to support the distribution of any joint costs related to the grant program. The circular, Section J(4)(6), also states that indirect cost proposals must be submitted to a cognizant federal agency for its approval. In addition, the indirect cost rate agreement, which the department and the United States Department of Education approved, states that the agreement is effective on the date of approval by the federal government.

Recommendation

The department should calculate its chargeable administrative costs using the indirect cost rates that the department and the United States Department of Education approved.

Inaccurate Federal Financial Reports

Finding

The department understated the federal share of disbursements included in the federal cash transactions report for June 30, 1990. The expenditure amounts included in this report did not agree with the amounts reported in the department's financial status report for the same period. According to a department accounting administrator, the expenditures listed on the cash transaction report were estimates because the expenditure information from the financial status report was not available at the time the cash transaction report was prepared. However, once the financial status report was completed, the department did not correct the estimated expenditures. As a result, the department understated the federal share of disbursements included in the cash transactions report for June 30, 1990, by approximately $4,235,000.

In addition, the department's June 30, 1990, financial status reports contained several minor clerical errors that caused the reports to overstate the federal share of expenditures by approximately $51,000.

We reported similar errors during our audit for fiscal year 1988-89. During our fiscal year 1989-90 audit, we noted that the department corrected the errors in subsequent financial reports.

Criteria
The Federal Office of Management and Budget, Circular A-102 revised, Subpart C, Paragraph 883A(b)(1), requires that financial reports contain accurate and reliable information.

Recommendation
The department should ensure that its financial reports contain accurate and reliable information.

Failure To Ensure Compliance With Department Audit Requirements

Finding
The department did not ensure that required annual audits were performed for grantees receiving federal funds. We reviewed 38 grants and determined that, during fiscal year 1989-90, the department should have received audit reports for 37 of these grants. However, the department received only 19 of the 37 required audit reports. For the other 18 grants, the department was unable to provide us with documentation to support that the audits had been performed. Moreover, of the 19 reports that the department received, 9 were not prepared within required deadlines. Without required audit reports from grantees, the department has no assurance that audits, if performed, are in compliance with federal regulations or that expenditures of federal funds by the grantees are in compliance with federal grant requirements.

We reported a similar finding during our audit for fiscal year 1988-89. In response, the department stated that the department's Internal Audit Unit had been assigned the responsibility to review these audits.

Criteria
The department's grant management handbook states that audits of grantees of federal funds shall be performed annually. Also, the handbook states that the audit shall be completed by the 15th day of the fifth month following the grantee's fiscal year. Further, the handbook states that the audit is to have adequate coverage to meet the United States General Accounting Office (GAO) standards for fiscal compliance.

Recommendation

The department should monitor grantees to ensure that audit reports are prepared and submitted to the department within required deadlines.

Background

The Community College Foundation (foundation) was established in October 1983 by the Board of Governors of the California Community Colleges. According to its articles of incorporation, the foundation's purpose is to assist and promote the educational activities of the Board of Governors on behalf of the California Community Colleges. Specifically, the foundation solicits grants and contracts, receives contributions, dispenses funds to support the educational programs and general welfare of the community colleges, and assists the colleges in fulfilling their role of service to the citizens of the State.

In March 1987, the foundation began receiving federal funds as one of the recipients under the establishment grant program. These grants are designated for improving community rehabilitation facilities and for training of individuals with handicaps. The foundation, through its headquarters in Sacramento, began administering these federal grants for developing high-technology centers (HTCs) that the foundation established at various community college campuses. These HTCs were designed to employ the latest computer technology to teach individuals with disabilities to use computers.

Deviation From Program Participation Requirements

Finding

The department continued to award federal funds to the foundation when the foundation did not meet the department's minimum requirements for continued participation in the establishment grant program. The department requires that a minimum of 51 percent of the clients served by the HTCs be department clients. However, the monitoring reports that the foundation submitted showed that it did not always meet the 51 percent requirement. We reviewed the 89 monitoring reports that the foundation submitted to the department for the period August 1987 through June 1990. We found that only 37 reports showed that the foundation met the department's 51 percent requirement. Moreover, in some of these 37 reports, individual HTCs reported participation rates of less than one percent. Since the foundation frequently did not meet the department's requirement that a minimum of 51 percent of the individuals served be department clients, the department has not ensured that the facilities were operated for the primary purpose of providing vocational rehabilitation services to individuals with handicaps.

Criteria

The Code of Federal Regulations, Title 34, Section 361.1, defines a rehabilitation facility as a facility operated for the primary purpose of providing vocational rehabilitation services to individuals with handicaps. To implement this regulation, the department established a policy requiring facilities to ensure that a minimum of 51 percent of the clients served under the establishment grants are department clients. Finally, the department included such minimum participation requirements in its grants and contracts with the foundation.

Recommendation

The department should require all rehabilitation facilities to comply with the requirements for participation in the establishment grant program.

Lack of Control Over Equipment

Finding

The department did not maintain sufficient controls over equipment that it purchased for the foundation with state and federal funds. These funds totaled more than $1 million. Even though the department began purchasing equipment for the foundation in 1987, it has not taken a physical inventory of the equipment. Instead, the department relies on a list of equipment that the foundation prepared. However, the total amount of equipment on the foundation's list is $1,382,810, while the department's records indicate the foundation should have $1,105,344 in equipment. The difference is $277,466. Until the department has taken a complete physical inventory, it cannot reconcile the difference in the amounts.

The department also does not have sufficient controls to ensure that equipment purchased for the foundation with federal funds is promptly returned from sites that may no longer be used as rehabilitation facilities. For example, the funding for grant employees was terminated at one HTC on June 30, 1989. However, the department allowed the equipment to remain at the site until July 1990. In addition, as of January 31, 1991, more than $23,000 in equipment remains at the foundation's headquarters in Sacramento even though it ceased providing services to HTCs on June 30, 1990. The department does not plan to reclaim this equipment until June 30, 1991. Finally, for 12 other HTCs whose grants terminated on or before June 30, 1990, the department has not received certifications from the colleges stating whether they will continue to operate the HTCs as rehabilitation facilities. The department has given these HTCs until June 30, 1991, to submit the certifications and until October 31, 1991, to return the equipment if they no longer participate in the program. Although the department believes that these 12 HTCs will continue as rehabilitation facilities, until the department obtains the certifications or recovers the equipment, it cannot ensure effective control and accountability for the equipment.

Criteria

The Code of Federal Regulations, Title 34, Section 74.140(b), requires that a physical inventory of equipment be taken and reconciled with the property records every two years. Further, Section 74.61(c) requires grantees and subgrantees to maintain effective control and accountability for all grant or subgrant cash, real and personal property acquired with grant support, and other assets.

Recommendation

The department should complete its physical inventory of the equipment at the foundation and all the HTCs as soon as possible. It should then reconcile any differences between its records and its physical inventory. The department should also immediately transfer the equipment remaining at the foundation's headquarters to a rehabilitation facility. Further, the department should ensure that it promptly receives from all colleges a certification stating whether they intend to continue operating the HTCs as rehabilitation facilities. The department should promptly recover equipment from the HTCs that no longer operate as rehabilitation facilities.

Omission From Inventory of Rehabilitation Facilities

Finding

The department did not include the foundation or the HTCs in the department's inventory of rehabilitation facilities. This inventory, which the department prepares every two yeas, lists rehabilitation facilities, their location, and the services they offer. Although the department began funding the foundation and HTCs in 1987, it did not include the foundation or HTCs in the inventory that it prepared in fiscal year 1987-88. In addition, it omitted 48 of the 60 HTCs from the inventory that it prepared in October 1990. As a result of not listing the foundation or the HTCs in the inventory, the department has not made the public aware of all the rehabilitation facilities and the services they offer.

Criteria

The Code of Federal Regulations, Title 34, Section 361.21, requires the department to maintain a state rehabilitation facilities plan, which includes an inventory of rehabilitation facilities and services available within the state.

Recommendation

The department should prepare an amendment to its facilities inventory to include all rehabilitation facilities that it omitted.

Department of Social Services

We reviewed the financial operations and related internal controls of the Department of Social Services (department) and the department's administration of 11 federal programs. These programs are the U.S. Department of Agriculture grants, Federal Catalog Numbers 10.551 and 10.568, and the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 93.020, 93.021, 93.023, 93.025, 93.026, 93.645, 93.658, 93.667, and 93.802 (formerly Federal Catalog Numbers 13.780, 13.781, 13.783, 13.786, 13.787, 13.645, 13.658, 13.667, and 13.802).

Improper Cash Management for Local Assistance

Finding

The department does not always properly control its cash management system for requesting federal funds for the federal share of the department's local assistance expenditures. As a result, the State lost approximately $1.2 million in potential interest income. Specifically, we noted the following conditions:

- The department did not promptly request federal funds to reimburse the State for In-Home Supportive Service expenditures that the department incurred. The department initially pays In-Home Supportive Service expenditures from the department's general fund and subsequently requests federal funds from the Social Services Block Grant to reimburse the general fund. Allowing the department five working days to request and receive reimbursement from the date the department initially paid the expenditures or from the date the department was subsequently notified that federal funds were available, the department was one to 28 days late in receiving reimbursement for the transactions we tested. As a result, the State lost approximately $668,000 in interest income.

- The department did not request approximately $4.1 million of approved Social Services Block Grant funds to reimburse the State for In-Home Supportive Service expenditures incurred in September 1989. As of September 30, 1989, the Social

Services Block Grant had an unspent balance of $4.1 million, which the department should have used to reimburse the general fund for expenditures previously incurred. Although we notified the department of this situation on at least three occasions between June and September 1990, the department did not request the block-grant funds until January 1991. As a result, the State lost approximately $450,000 in interest income.

- The department did not promptly request federal funds to reimburse the State for expenditures funded by the Aid to Families with Dependent Children program, the Adoption Assistance program, and the Refugee Demonstration Project program. We tested 23 transactions for these programs. Allowing the department 5 working days to request and receive reimbursement, the department was 8 to 119 days late in requesting reimbursement for 8 of the 23 transactions we tested. As a result, the State lost approximately $45,000 in interest income.

We reported similar weaknesses in our audit for fiscal year 1988-89. In its response, dated February 20, 1990, the department said it would try to improve its procedures for prompt reimbursement, but it noted that insufficient federal grants or delays in the receipt of federal grants complicate the reimbursement process. However, in determining the length of the department's delays in requesting federal reimbursement, we measured the delays after the date the department was notified of the receipt of or availability of grant monies.

Criteria

The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from grant funds for goods and services provided.

Recommendation

The department should promptly request federal funds to reimburse the department for federally eligible expenditures.

Delay in Disbursing Federal Funds

Finding

The department did not promptly identify and release federal food stamp funds to the counties. In September 1989, the department received approximately $5,000,000 in federal funds for county food stamp expenditures for federal fiscal year 1987-88. However, the department did not release the funds to the counties until October 1990. As a result, the State may have inappropriately earned interest income during the period it held the federal funds.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), states that cash advances to a recipient organization shall be limited to the minimum amounts needed and shall be timed to be in accord only with the actual, immediate cash requirements of the recipient organization in carrying out the purpose of the approved program or project. Also, the timing and amount of cash advances shall be as close as is administratively feasible to the actual disbursements by the recipient organization for direct program costs and the proportionate share of any allowable indirect costs.

Recommendation

The department should promptly identify the purpose of federal receipts and immediately release funds due to counties.

Weaknesses in Accounting Procedures

Finding

The department has weaknesses in accounting procedures for local assistance advances. Of 26 local assistance expenditure transactions that we tested, we noted the following weaknesses:

- The department did not promptly record expenditure adjustments totaling approximately $3 million to various counties under the In-Home Supportive Services program for the quarter ending December 31, 1989. As a result of the delay in adjusting expenditures to the counties, the State lost potential interest income of approximately $81,700.

- The department incorrectly recorded adjustments for 6 of the 26 transactions we tested. Of these 6 transactions, we noted two instances where adjustments were not recorded to the appropriate fiscal period, two instances where adjustments were not recorded to the appropriate fund, and two instances where adjustments resulted in an overpayment to one county of $13,000 and an underpayment to one county of approximately $5,300.

Failure to establish an effective system of internal accounting controls could result in undetected errors or irregularities.

In August 1990, we discussed these items with representatives of the department. They concurred with our findings and, as of January 1991, have corrected five of the seven errors we noted.

Criteria

The California Government Code, Section 13401, requires agencies to maintain an effective system of internal control. In addition, the California Government Code, Section 13403, requires that the system of internal control include recordkeeping procedures sufficient to provide effective accounting control over assets and expenses.

Recommendation

The department should ensure that it reconciles adjustments resulting from advance payments to counties. In addition, the department should review available financial information to ensure that the payments are as accurate as possible. Finally, the department should identify and support all accounting transactions that it makes in its accounting records.

Inaccurate Report of Federal Cash Transactions

Finding

The department does not accurately prepare the quarterly report of federal cash transactions for the various programs that require this report. Of these programs, we reviewed the Foster Care Title IV-E program, the Child Welfare Services program, the Family Support Payments to States–Assistance Payments program, and the Refugee and Entrant Assistance--State Administered program.

The federal government requires the department to report current cumulative net disbursements of federal funds and any remaining federal funds that the department has not disbursed at the end of each quarter. The department includes as disbursements any funds received from the federal government, whether or not they have been expended. As a result, the department did not report any excess federal funds on hand in the fiscal year 1989-90 cash reports that we tested, although department records indicate cash on hand for some of the programs. Specifically, for the quarter ending June 30, 1990, the department did not report any excess federal funds on hand for the Child Welfare Services program. However, according to the department's records, the department had approximately $317,000 in excess federal funds at the end of that quarter. Also, for the quarter ending March 31, 1990, the department did not report any excess federal funds on hand for the Foster Care Title IV-E program. However, department records indicate approximately $43,000 in excess federal funds at the end of that quarter. We reported a similar weakness for the audit of the prior fiscal year.

Criteria

The federal Department of Health and Human Services Manual for Recipients Financed Under the Payment Management System, Section 402, defines disbursements to be reported on the federal cash transactions report as actual payments made. The Code of Federal Regulations, Title 45, Section 74.61(a), requires the grantee's financial management system to provide accurate, current, and complete disclosure of the financial results of each grant program.

Recommendation

The department should report actual cumulative net disbursements of federal funds and any excess federal funds on hand at the end of each quarter.

Questionable Charges to Federal Programs

Finding

The department made questionable charges for personnel time to federal programs during fiscal year 1989-90. The department based the charges on methodologies that used information not current or on methodologies that did not appear to equitably charge federal and state funds. We observed questionable charges for personnel time in two areas:

- The Disability Evaluation Division charged approximately $11.4 million for clerical staff and $10.5 million for medical consultants for fiscal year 1989-90 to the Social Security--Disability Insurance program using percentages based on a time study performed during March 1988. That time study determined the average number of cases involving both state and federal issues that clerical and medical-evaluation staff handled in each district office. The division used this information to determine the percentage of clerical and medical-evaluation staff time that should be charged to the state and federal governments. However, because the division based its charges on a time study that has not been updated, the department cannot demonstrate that it has equitably charged costs to state and federal funds. Additionally, based on our testing, the percentages the division used to ultimately charge time to state and federal funds during fiscal year 1989-90 did not agree with the percentages that should have been charged based on the division's March 1988 time study. Using the percentages from the March 1988 time study, we determined that the division overcharged the federal government by approximately $38,000.

- The Regulations Bureau charged at least $206,000 during fiscal year 1989-90 to various programs using a method that charges programs based on the number of work packages processed for those programs. However, the time spent on the work packages varies according to the nature and length of the regulations involved. As a result, the department may be undercharging some programs and overcharging others because the method of charging time is not based on the actual time spent processing each work package.

Criteria

The Office of Management and Budget, Circular No. A-87, states that, to be allowable under a grant program, costs must be necessary and reasonable for the proper and efficient administration of grant programs. In addition, Circular A-87 requires that salaries and wages of employees chargeable to more than one grant program be supported by appropriate time distribution records and that the method used must produce an equitable distribution of time and effort.

Recommendation

The department should ensure that methodologies used in charging costs to federal grants allow for the proper allocation of those costs. In addition, the department should ensure that the charging of costs to federal grants is based on current information.

Federal Financial Reports Not Reconciled With Accounting Records

Finding

The department did not reconcile any of its federal financial reports prepared during fiscal year 1989-90 with departmental accounting records. Failure to reconcile federal financial reports with the accounting records can result in misstatements of claims that may go undetected.

We reported similar weaknesses in our audits for fiscal years 1985-86, 1986-87, 1987-88, and 1988-89. The department responded that it was in the process of seeking a redirection of staff to implement the reconciliation process.

Criteria

Circular A-102 revised, Subpart C, paragraph 883(b)(1) of the Office of Management and Budget requires grantee financial management systems to provide accurate, current, and complete disclosure of each grant program. Further, the State Administrative Manual, Section 20014, requires agencies receiving federal funds to reconcile federal financial reports with the official accounting records and retain all supporting schedules and worksheets for a minimum of three years.

Recommendation

The department should continue its efforts to implement a reconciliation process so that a complete, prompt reconciliation can be done for all reports.

Inappropriate Charging of Indirect Costs to a Federal Program

Finding

The department inappropriately charges indirect costs to the Temporary Emergency Food Assistance (Administrative Costs) program (TEFAP). In October 1986, the department began administering the TEFAP. Since that time, the department has charged indirect costs to the program as well as costs specifically incurred for the TEFAP. Indirect costs are costs incurred for common purposes such as operating the accounting unit or managing the branch that a program unit is in. The federal regulations that govern the TEFAP prohibit states from claiming federal reimbursement for a state's indirect costs or from including them in state costs that must be matched with federal funds. According to department records, the department charged approximately $140,000 in indirect costs to the TEFAP in fiscal year 1989-90.

We reported similar weaknesses in our audit for fiscal year 1988-89. In its response to our fiscal year 1988-89 management letter, the department concurred with our finding and stated that it would research procedures to ensure that all indirect costs are appropriately charged. However, the department now contends that the federal criteria regarding the allocation of indirect costs are inconsistent and that the department should be allowed to charge indirect costs to the TEFAP. Specifically, the department states that the Office of Management and Budget, Circular A-87, provides for the allocation of indirect costs in a way that would distribute these costs to all federal programs in a consistent and equitable manner. However, the Office of Management and Budget, Circular A-87, provides only the general rules for allocating costs. The TEFAP has specific rules, clarified by United States Department of Agriculture correspondence. These rules prohibit charging indirect costs to the TEFAP.

Criteria

The Code of Federal Regulations, Title 7, Section 251.8(d), states that program funds shall be used by state agencies only for those costs incurred in the storage and distribution of commodities. Section 251.3(f) defines storage and distribution costs as direct costs for the operation of the program and states that these costs include the costs of recordkeeping, auditing, and other administrative procedures required for program participation. Additionally, Section 251.9(c) states that matching contributions are allowable as state-level storage and distribution costs.

Further, United States Department of Agriculture correspondences dated March 29, 1984, and August 9, 1989, stated that only direct costs were allowable and that there was no provision for reimbursement of indirect costs.

Recommendation

The department should not charge indirect costs to the TEFAP. Additionally, the department should compute the amount of indirect costs it has charged to the TEFAP in the past and should return the federal funds, if required to do so.

Delays in Collecting Disallowed Costs or Adjusting for Incorrectly Claimed Costs

Finding

The department did not promptly collect disallowed costs from the county welfare departments. The department contracts with the Division of Audits of the State Controller's Office to conduct audits of the administrative expenditure claims records of county welfare departments. While conducting these audits, the State Controller's Office is responsible for determining whether county welfare departments have adhered to the regulations and instructions set forth by the federal government and the department. The department is responsible for analyzing and resolving any audit protest between the county welfare departments and the State Controller's Office. In addition, the department is responsible for collecting from the county welfare departments disallowed costs that the State Controller's Office identifies as a result of the audits.

From November 16, 1989, the date of our last review, to May 31, 1990, the department did not release any audits to the accounting unit so that funds could be recovered from the counties. We reviewed 10 of the 35 audits still in the "application process." In the application process, staff determine the type of funding, fiscal period, program, etc., to which the disallowed costs or incorrectly claimed costs relate. After allowing time for the department to resolve any audit protest or appeal, the delay for the 10 items we reviewed ranged from 515 days to approximately 5 years. For the 10 test items, the amount of disallowed costs was approximately $365,000 and incorrectly claimed costs totaled approximately $315,000. Because the audits are still in the application process, we are not able to determine what portion of the $365,000 in disallowed costs applies to federal funding.

We reported similar weaknesses in our audits for fiscal years 1985-86, 1986-87, 1987-88, and 1988-89. The department responded to our audit for fiscal year 1988-89 that it would review audit claims and set priorities for the workload and that it would make an effort to identify and train additional staff resources to perform the work. During a follow-up review conducted January 11, 1991, we determined that eight audits were released from the application process and sent to the accounting unit for cost recovery during a two-month period ending October 2, 1990, and an additional audit was released to the accounting unit on December 19, 1990.

Criteria

The Code of Federal Regulations, Title 45, Section 74.61(h), requires the State to follow a systematic method to assure prompt and appropriate resolution of audit findings and recommendations.

Recommendation

The department should promptly offset the disallowed costs of the county welfare departments against the current county claims or adjust for incorrectly claimed costs to ensure that excess funds are not held by the county welfare departments.

Noncompliance With Federal Audit Requirements

Finding

The department did not properly review independent audit reports of subrecipients submitted in fiscal year 1989-90. Of the three audit reports that the department received, one did not meet government auditing standards. Specifically, the report did not include a report on tests of compliance with applicable laws and regulations and a report on internal control. Additionally, the department did not ensure that independent audits were conducted for two subrecipients whose contracts expired on September 30, 1989.

Without proper audits, the department cannot ensure that subrecipients are complying with applicable federal laws and regulations. In addition, acceptance of audit reports that do not comply with federal regulations may result in perpetuation of substandard reporting because subrecipients may believe their audit reports meet the requirements.

Criteria

The Office of Management and Budget, Circular A-128, requires the State to determine whether subrecipients are in compliance with applicable laws and regulation. The Office of Management and Budget, Circular A-110, requires that nonprofit subrecipients have an organization-wide independent audit at least every two years. The audit is to include tests of financial transactions as well as compliance with the terms and conditions of federal grants and other agreements.

Recommendation

The department should ensure that audits of subrecipients are performed as required and that such audits meet federal requirements.

Deficiencies in Administering State Contracts

Finding

The department did not comply with the California Public Contract Code and the State Administrative Manual in establishing and maintaining contracts with vendors. Of the 36 contracts that we examined for approximately $1.3 million in services, we noted the following weaknesses:

- The department did not ensure that contracts had been properly executed prior to the payment of claims. For two contracts we examined, the department paid requests for advances even though previously authorized funds were exhausted and the Department of General Services had not approved amendments to increase the total amount of funds authorized. The amendments were subsequently approved 14 and 163 days later, respectively.

- For two contracts we examined, the department changed the contracts without obtaining approval from the Department of General Services, as required by the State Administrative Manual.

- The department did not ensure that contract payments were in accordance with the terms of the contract. We found one contract that required that 10 percent of each invoice be withheld until completion of the contract. For the period July 1988 to January 1990, the department did not withhold the required amount for claims the vendor submitted. Failure to withhold partial payment provides less assurance that contractors fully adhere to the terms of the contract before the State renders final payment.

- Four of the contracts were not properly approved by the Department of General Services before the contractor began work.

- The department did not have a resume on file for one of the consulting-services contractors who had not performed a previous contract for any state entity. Also, for four of the contracts that have been completed, the department did not have a contractor evaluation form on file.

Criteria

The Public Contract Code, Sections 10295, 10335, and 10360, states that specified types of contracts are of no effect unless and until approved by the Department of General Services. These code sections further state that a contract, if approved by the department, shall be effective from the date of such approval. The State Administrative Manual, Section 1247, states that contracts that were subject to the approval of the Department of General Services must also have such approval for a modification or amendment unless the amendment only extends the original time for completion of performance for a period of one year or less. The Public Contract Code, Section 10346, states that contracts may provide for progress payments to contractors for work performed or costs incurred in the performance of the contract, provided that not less than 10 percent of the contract amount shall be withheld pending completion of the contract. Also, at the time of our testing, the Public Contract Code, Section 10371(e), stated that no consulting services contractors shall be awarded a contract unless the department has reviewed a contractor evaluation form on file with the Department of General Services. Section 10371 also required that if the contractor had not performed a previous contract for any state entity, a completed resume shall be attached to the contract. The State Administrative Manual, Section 1252, states that a contractor evaluation form must be prepared within 30 days after the completion of every contract for $1,000 or more.

Recommendation

The department should follow the requirements of the California Public Contract Code and the State Administrative Manual in establishing and maintaining contracts with vendors.

Noncompliance With the Direct Service Contract Reform Act

Finding

The department is not resolving, within the goal of 60 days, disputes with nonprofit organizations that contract with the department through direct service contracts. Specifically, disputing parties did not resolve within 60 days three of the five disputes we reviewed. As of August 17, 1990, the delays in resolving the disputes ranged from 210 days to 6.8 years. When disputes are not resolved promptly, the direct service contractors and the department may incur increased costs while attempting to resolve the disputes.

We reported a similar weakness in our report entitled "The Departments We Reviewed Within The Health And Welfare Agency Are Not Complying With the Direct Service Contract Reforms." We issued this report in July 1989. The department responded that some of the disputed issues are highly technical and complex and require more than 60 days to resolve.

Criteria

The Health and Safety Code, Section 38050(b), provides that, in a contractual relationship between the department and private nonprofit organizations, the parties should set a goal of no more than 60 days from receipt of a complaint to resolution.

Recommendation

The department should resolve disputes with direct service contractors within 60 days.

Delays in Preparing Reconciliations With the State Controller's Office

Finding

The department does not promptly prepare reconciliations with the State Controller's Office. We reviewed monthly reconciliations for six appropriation balances for the six-month period from January through June 1990 for a total of 36 reconciliations. Of the 36 reconciliations that we reviewed, 6 were not prepared within the department's 60-day requirement. These reconciliations were prepared from 16 to 85 days late. When reconciliations are not prepared promptly, errors in both agency accounts and in central accounts maintained by the State Controller's Office cannot be corrected as they occur. We observed a similar weakness during our financial audit of fiscal year 1988-89.

When reconciliations are not prepared promptly, the accounting records may be inaccurate, and management does not have correct information on which to make decisions pertaining to fiscal policy and procedures.

Criteria

The State Administrative Manual, Section 7900, requires agencies to prepare reconciliations within 30 days of the preceding month. The department's position is that, because of the time involved in processing CALSTARS reports, and the number of reconciliations involved, the department cannot comply with the 30-day requirement. As a result, the department implemented a policy that states that monthly reconciliations will be performed within 60 days of the preceding month.

Recommendation

The department should prepare reconciliations with monthly reports of the State Controller's Office within at least 60 days of the preceding month if it cannot comply with the 30-day requirement stated in the State Administrative Manual.

Noncompliance With Federal Requirements

Finding and Criteria

We noted the following instances where the department did not always comply with administrative requirements of the federal government:

- On one of the 21 invoices that we tested that support payments made by the Disability Evaluation Division (division), the division did not document that it had authorized the services to be performed. Also, the division's Oakland branch could not locate one of the six invoices we requested. The department charged these payments to the federal Social Security–Disability Insurance program. The Office of Management and Budget, Circular A-102 Revised, Subpart C, paragraph 883A(b)(6), requires the department to maintain accounting records that are supported by source documents.

- The department completed only seven pages of the ten-page quarterly statement of expenditures for the Foster Care--Title IV-E program for the quarter ended June 30, 1990. Revised federal reporting instructions from the Administration for Children, Youth, and Families indicate the information to be included on the quarterly statements of expenditures. Effective with the quarter ending June 30, 1990, the department is required to submit a ten-page quarterly statement of expenditures. Previously, the department was only required to submit a two-page report. The federal Department of Health and Human Services estimated that the revised statement could be completed in approximately 25 hours. However, in a letter submitted to the federal government on May 14, 1990, the department claims that this figure is inaccurate. Also, the department stated that the new report would require extensive system modifications and a significant increase in staff time. As a result, the department would not be able to provide all the information required for the new report.

- The department does not always ensure that counties properly review and maintain timesheets for In-Home Supportive Service (IHSS) providers. As a result, the department overpaid 2 of the 26 providers we tested. Additionally, one of the 26 provider timesheets that we requested from the counties could not be located. The Office of Management and Budget, Circular A-102 Revised, Subpart C, paragraph 883A(b)(6), requires that the department and counties maintain accounting records that are supported by source documents.

Although individually these instances of noncompliance may not appear to be significant, they are deviations from federal requirements, which are designed to ensure that the public's resources are not vulnerable to abuse.

Recommendation

The department should improve its compliance with each of the federal requirements.

Legislative, Judicial, and Executive

Office of Emergency Services

We reviewed the Office of Emergency Services' (office) administration of the U.S. Emergency Management Agency grant, Federal Catalog Number 83.516.

Delay in Disbursing Federal Grant Monies

Finding

The office's cash management system does not minimize the time between the receipt of federal Disaster Assistance funds and the disbursement to applicants. For 16 of the 47 claims that we reviewed, the State held the federal funds 6 to 56 days before disbursing them to applicants. The average number of days between receipt and disbursement for these 16 claims was approximately 19 days. Some of this delay can be attributed to the time the State Controller's Office takes to process the disbursements. We observed a similar weakness during our audit of the office for fiscal year 1988-89. However, while there were still delays in disbursing federal funds during fiscal year 1989-90, we noted that the office has reduced these delays.

Criteria

The Code of Federal Regulations, Title 31, Section 205.4(a), requires that the timing and amount of cash advances be as close as administratively feasible to the actual disbursement by the recipient organization.

Recommendation

The office should continue to take measures that will minimize the time elapsed between receipt of federal funds and disbursement to applicants.

Delay Between Receipt and Return of Federal Refunds

Finding

The office does not always promptly remit to the Federal Emergency Management Agency (FEMA) refunds of federal funds that applicants have not used. The FEMA bills applicants for amounts they are to refund to the FEMA. Applicants send the refunds to the office, and the office remits the refunds to the FEMA. For 7 of the 16 refunds we reviewed, the office took 33 to 133 days to remit the refunds to the FEMA. For these 7 refunds, the average number of days between the receipt of funds from the applicants and remittance to the FEMA was approximately 64 days. We observed a similar weakness during our audit of the office for fiscal year 1988-89.

Criteria

The Code of Federal Regulations, Title 44, Section 205.120 (c), states that bills for collection are due upon receipt. We interpret this to mean that the State should promptly return to the FEMA amounts refunded by applicants.

Recommendation

The office should promptly remit to the FEMA refunds from applicants.

Board of Equalization

We reviewed the financial operations and related internal controls at the Board of Equalization (board).

Insufficient Backup Procedures for Electronic Data Processing System

Finding

The board currently has no access to off-site backup equipment for its electronic data processing (EDP) system that it can use if a major disaster renders the computer equipment unusable. According to a board official, the board does not have a contractual agreement with another facility for off-site backup equipment. Moreover, this board official stated that no facilities in the western region of the United States have data processing equipment that is both compatible with the board's system and sufficient for the board's volume of work. A major shutdown of the board's EDP facilities could result in processing delays and in the loss of revenues to the State and to local governments.

We reported a similar weakness during our financial audits of fiscal years 1987-88 and 1988-89. The board, in a letter to the Office of Information Technology dated January 31, 1991, states that it plans to convert its computer processing to the system used by the Stephen P. Teale Data Center. This data center would have backup computer equipment available.

Criteria

The State Administrative Manual, Section 4843.1, requires each department to maintain an operational recovery plan identifying the computer applications that are critical to agency operations and the agency's plans for resuming operations following a disaster affecting those applications. These backup procedures would involve arranging for access to an alternative EDP system. The State Administrative Manual, Section 4842.11, states that a critical application of an EDP system is so important to the State that the loss or unavailability of the application is unacceptable.

Recommendation

The board should continue its efforts to obtain backup facilities for its EDP system.

Health and Welfare Agency

We reviewed the Health and Welfare Agency's (agency) administration of the U.S. Department of Health and Human Services grant, Federal Catalog Number 93.025 (formerly Federal Catalog Number 13.786).

Lack of Documentation for Charges to the SLIAG

Finding

The agency could not provide documentation to support one of its charges to the SLIAG. Specifically, the agency could not document that an employee was performing grant work during a month for which the agency charged the grant approximately $3,500 for the employee's salary. Without adequate documentation, the agency could not ensure that its charges to the grant were allowable.

Criteria

The Code of Federal Regulations, Title 45, Section 74.61(f), requires the agency to establish procedures for determining the reasonableness, allowability, and allocability of costs charged to the grant.

Recommendation

The agency should keep documentation demonstrating the reasonableness, allowability, and allocability of all costs charged to the SLIAG.

State Treasurer's Office

We reviewed the financial operations and related internal controls at the State Treasurer's Office (office).

Insufficient Support for Bank Account Reconciliations

Finding

The State Treasurer's Office (office) did not sufficiently support amounts reported on its reconciliations of the centralized State Treasury System (CTS) bank accounts. Specifically, the March 1990 reconciliation report contained an adjustment totaling approximately $29 million. A corresponding detail report differed by approximately $5.8 million, and the office could not provide sufficient records to support the difference. According to the office's acting fiscal officer, this situation occurred because the office has begun a new bank reconciliation procedure that uses two different computer programs. Further, differences occurred between the two programs because both programs were not implemented at the same time. Because the program used to prepare the reconciliation report does not contain sufficient detail, we could not reconcile the differences between the two programs and, therefore, we could not assure ourselves that the differing amounts represented the same transactions.

Subsequently, the June 1990 reconciliation report contained an adjusting entry for approximately $23 million, and the two computer programs differed by approximately $300,000.

Criteria

The California Government Code, Section 13403, requires offices to ensure that a satisfactory system of internal accounting and administrative controls is in place to provide effective accounting control over assets, liabilities, revenues, and expenditures. Such controls would include accurate preparation of bank reconciliations.

Recommendation

The office should prepare its reconciliations of its CTS bank accounts so that adjusting entries are sufficiently supported.

Bank Reconciliations Not Prepared Promptly

Finding

The office did not promptly prepare reconciliations of the centralized State Treasury System (CTS) bank accounts. State agencies deposit money into one of eight CTS bank accounts in seven banks, and the State receives credit for the deposit on the day the bank records the deposit. The office receives daily statements from each of the seven banks and is required to reconcile the bank records with its own records monthly. We reviewed the office's monthly reconciliations of the eight CTS bank accounts for September 1989, March 1990, and June 1990 and found that the reconciliations were prepared over seven, five, and three months late, respectively.

Failure to promptly reconcile its CTS bank accounts may result in a bank or office error going undetected for a prolonged period. According to the office's acting fiscal officer, the office has been working for several years to implement an automated bank account reconciliation system. The new system is now working. However, as noted in the first finding, the office is having some problems fully implementing the system.

Criteria

The State Administrative Manual, Section 8060, requires that all bank and centralized State Treasury System accounts be reconciled promptly at the end of each month.

Recommendation

The office should prepare reconciliations of its CTS bank accounts promptly at the end of each month.

Resources

Department of Water Resources

We reviewed the financial operations and related internal controls at the Department of Water Resources (department).

Inaccurate Reporting of Liability Accruals

Finding

The department inaccurately calculated certain liability accruals for the Water Resources Revolving Fund. Specifically, the department omitted, from its liability accruals, invoices totaling approximately $482,100 for mobile equipment received before June 30, 1990. Additionally, the department did not include, in its liability accruals, other invoices totaling approximately $252,800 for goods and services received before June 30, 1990, related to two contracts. Further, the department made errors totaling a net $76,200 when calculating accruals for two contracts. As a result of these calculation errors, the department understated its accounts payable by approximately $811,100, understated its equipment account by approximately $482,100, and understated its expenses by approximately $329,000.

Additionally, the department did not properly classify amounts owed to other funds within the State. As a result, for the items we reviewed, the department overstated its accounts payable and understated its due to other funds account by approximately $1,465,000 at June 30, 1990.

Further, the department did not identify encumbrances included in its liability accruals. Encumbrances are amounts to be paid for goods and services ordered but not received by June 30. Under generally accepted accounting principles, expenses and liabilities should not include encumbrances. Our analysis of the liability accruals for the Water Resources Revolving Fund showed that the department included approximately $385,200 of encumbrances in its liability accruals. If the department does not identify the amount accrued for encumbrances, the State Controller's Office cannot prepare the financial statements for the State in accordance with generally accepted accounting principles. We observed a similar weakness during our financial audit for fiscal year 1988-89.

Criteria

The State Administrative Manual, Section 10544, requires state agencies to review their records to ensure that they have accurately recorded all amounts owed to others. Additionally, the State Administrative Manual, Section 7630, defines how amounts due to other funds should be classified. Finally, the State Administrative Manual, Section 10544, requires state agencies to prepare a detailed list of all accounts payable at June 30. This list should identify encumbrances.

Recommendation

The department should properly report liability accruals for the Water Resources Revolving Fund.

Weaknesses in Accounting for Fixed Assets

Finding

Department weaknesses in accounting for fixed assets caused errors in the department's financial statements. The effect of these errors, some of which offset each other, is that the department understated its accumulated depreciation by approximately $116,200, understated its fixed assets by approximately $65,400, and understated its expenses by approximately $50,800. We noted the following specific conditions:

- The department did not record the full cost of computer equipment acquired by the department's design branch. As a result of its error, the department understated equipment and overstated expenses by approximately $130,400 at June 30, 1990.

- The department's computer system had not calculated depreciation totaling approximately $70,200 for 31 pieces of mobile equipment as of June 30, 1990. The depreciation problems appear to be long-standing; according to its records, the department had owned 25 of the 31 pieces of equipment for 19 to 31 months as of June 30, 1990. In July 1990, the department attempted to correct the errors in its computer system but was not entirely successful. Additionally, the department did not make the corrections to its fiscal year 1989-90 financial statements. As a result, the department understated depreciation expense and accumulated depreciation by approximately $70,200 at June 30, 1990.

- The department did not analyze costs related to its office refurbishment project to determine if any costs should be recorded as expenses rather than assets. Specifically, the department capitalized as an asset approximately $65,000 of costs associated with storing furniture. Because these were unforeseen costs made necessary because of delays in the project, the costs should have been treated as expenses for the period in which the delays occurred. As a result, the department overstated its "Building-Office Refurbishment" account and understated expenses by approximately $65,000 at June 30, 1990.

- The department had not depreciated any of the nearly $1.1 million in costs that it had capitalized for the office refurbishment project as of June 30, 1990, although the department had completed work for some of the offices before that date. For example, work totaling approximately $189,100 for the Division of Safety and Dams refurbishment had been completed by October 1989; however, the department did not begin depreciating the costs at that time as it should have. We estimate that, as a result of not depreciating any of the costs related to completed components of the project, the department understated depreciation expense and accumulated depreciation by at least $46,000 at June 30, 1990.

Criteria

The California Government Code, Section 13403, states that a satisfactory system of internal control includes a system of recordkeeping that provides effective accounting control over assets and expenditures. Additionally, the State Administrative Manual, Section 8616, defines depreciation as the asset's actual cost or other basis, less the estimated residual value, distributed over the useful life of the asset. Further, the State Administrative Manual, Section 8602, lists the conditions that must be met before costs are capitalized as assets. Finally, the State Administrative Manual, Section 8613, defines improvements to an asset as costs that make an asset better, such as those that extend an asset's life, increase its capacity, or lower its operating costs.

Recommendation

The department should ensure that it records all costs related to equipment that it acquires. Additionally, the department should calculate depreciation on all of its depreciable assets based on the asset's estimated useful life. Further, the department should analyze individual costs of its office refurbishment project to determine if the costs should be capitalized. Finally, the department needs to ensure that it records depreciation for components of the office refurbishment project from the date that the work is completed.

Need To Strengthen Controls To Prevent Duplicate Payments

Finding

The department needs to strengthen its controls to prevent duplicate payments. Duplicate payments cause staff extra work to recover the overpayments and to maintain the department's accounting records properly. Additionally, the department risks not recovering the overpayments.

Specifically, the department paid a $21,000 invoice twice because it processed both the original invoice and a copy. Also, the department paid a $67 invoice twice. According to a written explanation provided to the vendor, the department paid the $67 invoice once based on the sub-purchase order and again based on the invoice that the vendor submitted. The department later recovered the two duplicate payments.

Additionally, the department made at least $4,700 in duplicate payments to utility companies because the department included the amount designated as "previous balance" when paying 12 invoices, even though the department had already paid the previous balances. Additionally, the department made duplicate payments totaling approximately $100 to utility companies because it made other errors when paying two invoices. Because the department has on-going accounts with the utility companies, the department recovers excess payments later by having its accounts credited. However, the department should not be dependent upon others to identify its overpayments.

Criteria

The State Administrative Manual, Section 8422.1, requires state agencies to determine, when submitting invoices for payment, that they have not previously paid the invoiced amount. Additionally, the Department of Water Resources instructions for paying utility invoices state that staff should be paying only current charges on invoices and should not pay the previous balance on the invoice unless they are absolutely sure that the department has not made a previous payment.

Recommendation

The department should ensure that it has sufficient controls to prevent duplicate payments. Additionally, the department should not pay the "previous balance" on utility invoices unless staff have determined that it is appropriate to do so.

State and Consumer Services

Franchise Tax Board

We reviewed the financial operations and related internal controls at the Franchise Tax Board (board).

Lack of Procedures To Prevent Erroneous Refunds or Erroneous Billings to Bank and Corporate Taxpayers

Finding

The board does not have the necessary procedures in all units to prevent erroneous tax refunds or erroneous billings to bank and corporate taxpayers. In a detailed review of 54 bank and corporate accounts, we identified the following units that lacked necessary procedures:

- The transcriptions unit in the operations division did not have a procedure requiring a review of the final worksheets that were a basis for calculating refunds. On January 12, 1990, this weakness contributed significantly to an erroneous refund the board issued to one corporation. The board refunded this corporation approximately \$20.4 million more than it should have. As a result, the State lost approximately \$574,000 in interest during the four months that the taxpayer held the overpayment. When the board's management became aware that the transcriptions unit needs to review all final refund worksheets, the board implemented a procedure in this unit to review these worksheets.

- None of the board's units has procedures to inform employees how to handle a unique federal tax credit called a claim of right. As a result, board employees did not determine that a corporation incorrectly claimed this credit for more than \$10 million in one year and \$2.8 million in another year. After we questioned the board's handling of this credit, the board reviewed the credit and determined that the corporation must file an amended tax return. A board official confirms that, based on the board's interpretation of law, the corporation will owe the board approximately $736,000 for the two years plus interest of more than $146,000. The interest will continue to accrue until the amounts are paid in full. When we brought this weakness to the board's attention, it agreed to implement procedures, in April or May 1991, to instruct its employees in processing these unique transactions.

- The transcriptions unit in the operations division did not have formal procedures to ensure that it processed refund documents only once. As a result, the unit processed one document two times and sent two refund checks of $688,025 to the same corporation. The corporation returned one of the refunds. In another example, the unit processed a preliminary refund worksheet twice and sent the corporation a second refund of $272,857. This corporation also returned the second refund. In August 1990, the unit implemented a formal procedure to mark processed documents so they do not process them a second time.

- Some of the board's units do not have a procedure to alert one another that they are refunding the same money. As a result, the bank and corporation audit unit processed a tax refund of approximately $259,000 from an amended return even though another unit had previously processed a similar refund from the taxpayer's account. The corporation returned the erroneous refund to the board.

- The board's technical audit support unit did not have a documented procedure requiring it to review complex interest calculations when law required the board to pay interest on corporate refunds. Because it did not review these calculations to ensure that they were correct, the unit processed some refunds based on incorrect calculations. We identified three corporations that were underpaid by more than a total of $56,000 and one that was overpaid by more than $26,500. The board has determined the statute of limitations prevents it from correcting one of the three underpayments now. The overpayment was corrected when the corporation returned the warrant. In November 1990, the board implemented a policy in this unit to review all refunds and interest calculations greater than specified dollar amounts.

We are unable to ensure that the corrective actions already taken, or those being planned, are sufficient to resolve these issues. We will review the effect of any changes by the board in our next audit.

Criteria

The California Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires that the system of internal control include authorization procedures sufficient to provide effective control over expenditures and an effective system of internal review. Further, the Revenue and Taxation Code, Section 26080.1, states that, when interest on a claim for refund has been disallowed, the board's action is final unless, within 90 days of notification, the taxpayer appeals in writing to the Board of Equalization.

Recommendations

To ensure that its units refund or bill corporate taxpayers correctly, the board should take the following actions:

- Continue reviewing all final refund worksheets;
- Proceed with its plan to implement procedures for processing claim of right transactions;
- Review its procedures for processing original and amended returns to ensure that corporations receive only refunds to which they are entitled; and
- Review all refund and interest calculations greater than specified dollar amounts.

Established Review Procedures Are Insufficient

Finding

For some units, the board's established bank and corporate income tax review procedures are not sufficient to prevent erroneous adjustments to taxpayers' accounts. During our review of the 54 bank and corporate accounts that we discussed in the previous item, we also identified instances where erroneous transactions were reviewed, approved, and posted to taxpayers' accounts despite the units' review procedures. In some cases, these adjustments also resulted in erroneous refunds or erroneous billings to taxpayers. We identified the following specific examples of insufficient review procedures in the bank and corporation processing unit:

- The unit incorrectly approved an assessment of a corporate taxpayer's penalty for approximately $21.4 million, which should have been approximately $2.1 million;

- The unit made an error of approximately $3.1 million in preparing a corporation's refund worksheet and sent the corporation the erroneous refund. The corporation returned the refund;

- The unit incorrectly assessed more than $1 million in penalties for one corporation;

- The unit incorrectly processed a refund for $298,000, which the corporation returned;

- The unit did not assess penalties totaling more than $3,600 on one account; and

- The unit incorrectly adjusted a taxpayer's account, and sent the taxpayer a letter demanding payment of $345.

We also found that the liaison unit incorrectly reduced, by $44,000, the interest owed by a corporation.

Since a board employee reviewed and approved each of these transactions, the reviewers appear either to have not received sufficient training or to have not allowed sufficient time to perform an adequate review, or there are additional reasons for the inadequacies, which the board should identify.

We found further evidence that the board's established review procedures may be insufficient or not clearly understood by all employees:

- Two employees in the technical audit support unit prepared three documents to adjust two taxpayers' accounts by more than $22 million. After signing as the preparer, they improperly signed their supervisor's initials as the reviewer. In November 1990, the board implemented procedures that substantially strengthen the review procedures in this unit.

- An employee in the bank and corporation processing unit completed a document to adjust a taxpayer's account by more than $32,000. The employee then improperly signed his initials as the reviewer and his supervisor's initials as the creator of the transaction.

In these last two examples, erroneous adjustments would not have been identified because the transactions were not independently verified. In November 1990, the board issued a memo to each of its bureau directors affected by the provisions of the memo to remind them of the required review procedures.

Criteria

The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires that the system of internal control include authorization procedures sufficient to provide effective control over expenditures and an effective system of internal review.

Recommendations

The board should ensure that its employees are adequately trained before they are allowed to review and approve other employees' work. In addition, it should ensure that reviewers have sufficient time to perform detailed reviews of complex calculations. The board should also determine if some other cause exists for the insufficient reviews. The board should consider implementing additional review procedures to ensure that significant tax refunds or billings are correct before they are mailed to taxpayers.

Weaknesses in the Personal Income Tax System

Finding

The board has weaknesses in the system that it uses to assess, collect, and refund personal income taxes. As a result of these system weaknesses, the board overcharges some personal income taxpayers, and in other cases, makes erroneous refunds to them. We found the following specific examples of weaknesses in the personal income tax system:

- The board's procedures do not ensure that significant billings to taxpayers are properly supported or accurate before it mails them. As a result, we identified an erroneous billing for approximately $14.4 million that was sent to a taxpayer in December 1989 although the taxpayer should not have received any billing.

- The board's contract collection unit does not have written procedures that require prompt follow-up of previous billings, even when they are significant. As a result, when the $14.4 million billing mentioned above appeared on a monthly printout of open billings, it was not promptly followed up. Although the billing was issued in December 1989, the board did not determine that it was an erroneous billing until we questioned the billing in December 1990.

- The board's review process for complicated personal income tax refunds is not sufficient to identify all errors. As a result, we found that the board incorrectly calculated and overpaid approximately $1,700 in interest on a tax overpayment that was reviewed, approved, and refunded to the taxpayer.

- The board's automated system overcharges some taxpayers who are assessed certain penalties because a system deficiency assesses interest before the date the taxpayers are notified of the penalties. Based upon information provided to us by the board, we estimate that this system deficiency, which apparently resulted from changes to the system in 1985, could affect the billings it sends to more than 37,000 taxpayers each year. For example, we identified one taxpayer who was overcharged approximately $1,500 in interest on a penalty of $229,000. To correct this deficiency, the board is currently implementing a procedure change, and it plans to implement system changes by May 1991.

- The board did not sufficiently test a computer program that it used to process renter's credit refunds. As a result, we found that the board overpaid 184 taxpayers for renter's credit refunds totaling more than $14,000. The board believes it has corrected this system weakness, but it has concluded that it would not be cost beneficial to attempt to recover the overpayments from these taxpayers.

- Under certain circumstances, the board's personal income tax system processes refunds even though the taxpayer may owe the board money. For example, we identified a refund for $10,000 that was processed even though the taxpayer's account showed that he owed the board the $10,000. After making this refund, the board notified the taxpayer that the refund was in error, and the taxpayer eventually returned the amount. A board official initially expected that its new personal income tax system, scheduled to begin operating in late 1992, would correct this weakness. However, the Department of Finance now proposes to discontinue funding for the board's new personal income tax system unless the board addresses the department's specific concerns. Therefore, the board is presently unable to estimate when this weakness will be corrected.

- The board's automated system is unable to correctly calculate large assessments when the interest, the penalty, or a combination of the two totals $10 million or more. Specifically, the system truncates the amounts that are greater than nine digits. This could result in underbilling taxpayers if the board is required to initiate such a large assessment. After we identified this weakness, the board initiated steps to resolve it.

Criteria

The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires that the system of internal control include authorization procedures sufficient to provide effective control over revenues and expenditures and an effective system of internal review. The Revenue and Taxation Code, Section 18689(c), that was applicable during fiscal year 1989-90, required that interest on a penalty be imposed from the date of notice of the proposed assessment to the date of payment. The State Administrative Manual, Sections 4842.1 and 4842.11, specify actions that agencies should take to avoid or reduce risks to acceptable levels when using information technology.

Recommendation

The board should take the following actions to improve the system that it uses to assess, collect, and refund personal income taxes:

- Develop and implement sufficient written procedures that require a mandatory review, before mailing, of all bills that exceed specific dollar amounts;

- Develop and implement written procedures that require prompt follow-up of all significant outstanding bills;
- Analyze the established procedures to review complex personal income tax calculations and determine if the procedures can be improved;
- Identify and promptly implement the programming changes necessary to ensure that taxpayers are not assessed interest before the date they are notified of certain penalties;
- Establish procedures to ensure that the board sufficiently test and approve all future computer programs so that potential weaknesses are identified and resolved before placing the programs into production;
- Identify the system changes required to eliminate refunds to taxpayers who owe the board money. If funding for the new system is discontinued, the board should implement the identified changes in the current system; and
- Complete the necessary steps to resolve the truncation deficiency so that large assessments are not erroneously reduced.

Weaknesses in Resolving Credit Balances

Findings and Criteria

The board has not sufficiently resolved identified weaknesses in its procedures to resolve credit balances on its bank and corporation tax system. Consequently, some taxpayers did not receive tax refunds they were entitled to receive. Moreover, in some cases, the statute of limitations prevents the board from making these refunds now.

The board's internal audit unit initially identified numerous weaknesses on March 28, 1989, in a draft audit report. In response to the draft audit report, the board assembled a study team that analyzed the weaknesses and recommended changes to the board's policies, procedures, and automated system. Although the draft audit report was issued 23 months ago and the study team completed its five-month study 17 months ago, the final audit report was not completed until August 1990. The board's executive management responded to the final report on November 2, 1990. However, this response did not sufficiently address all weaknesses identified in the draft and final audit reports, including those resulting in taxpayers not receiving refunds of overpaid taxes.

The board's automated bank and corporation tax system identifies a potential tax overpayment on a taxpayer's file as a credit balance. For example, a credit balance is created when a taxpayer submits a tax payment in response to a Notice of Proposed Assessment (NPA) from the board and then files a claim for a refund of the assessed tax that was paid under protest. An NPA is a notice informing a taxpayer that the board believes the taxpayer owes additional tax. The taxpayer's payment in response to this notice is considered a "deposit."

When a taxpayer submits full payment of the NPA and files a claim for a refund of the amount under protest, the final resolution of the claim may require years to complete. When it is complete, any portion of the "deposit" due to the taxpayer, including accrued interest, is either refunded to the taxpayer or is used by the board to offset any amount of tax due.

Since 1951, statutes in the Revenue and Taxation Code have stated that, when the board finds that taxes have been overpaid for any reason, the board must credit the overpayment against any tax due from the taxpayer and refund the balance.

Although this code requires the board to refund any tax overpayment due to the taxpayer that it finds, the board's senior legal counsel maintains that corporate taxpayers are responsible for keeping records of their payments and for computing their tax liabilities. Therefore, according to the senior legal counsel, "there is no affirmative legal requirement that the board review taxpayer accounts or refund amounts for which the taxpayer has filed no claim."

Based on this reasoning, the board does not believe the law requires that it examine or review credit balances on its automated bank and corporation tax system to determine whether these are actual tax overpayments, unless the taxpayer first files a claim.

In 1986, the California Revenue and Taxation Code, Section 26071, was revised to state that, if the board finds there has been an overpayment of tax for any reason, the overpayment may be credited against any amount then due, and the balance must be refunded to the taxpayer. A technical advice memorandum, approved by the board's chief legal counsel, that interprets this change in the statute concludes that these tax overpayments must be refunded even if the taxpayer has not filed a formal refund claim. However, since the board does not automatically refund credit balances identified on its bank and corporation tax system, it must examine the credit balances to determine if they are tax overpayments that must be refunded.

Although the board has taken action to resolve its weaknesses in reviewing credit balances, it has no written requirement to resolve bank and corporate credit balances promptly, and it still has not completed its review of taxpayer accounts that may be substantially affected and that were identified by the internal auditors. As of February 13, 1991, the board was still reviewing more than 50 accounts, with potentially significant errors. In addition, 68 accounts with credit balances of more than $4.5 million, which were previously removed from the credit follow-up file, were sent to the board's bank and corporation audit unit for additional review and potential refunds.

During our review, we also identified other instances when reviews of credit balances were not completed promptly. For example, a corporate credit balance of approximately $90,000 from tax year 1982 that we identified in March 1990 was not refunded until we made an additional inquiry in December 1990. Because the board did not refund the credit balance until December 1990, the taxpayer received $45,000 in interest on the refund. In another example, the board had not resolved a corporate credit balance of approximately $62,000 that had existed on a corporate taxpayer's account since December 1986. As a result of our inquiry, in December 1990, the board refunded this amount with additional interest of approximately $32,000. In a third example, an erroneous credit balance of approximately $14,000 remained on a taxpayer's account for more than 22 months. The board did not eliminate it until we identified it. The time it takes to resolve these credit balances is critical because delays in resolving credit balances that result in refunds cause the State to incur unnecessary interest expense. (See a related discussion in a following item titled "Tax Refunds Delayed.")

In addition to causing unnecessary interest expense, resolving these accounts with credit balances is critical because taxpayers may be denied refunds if the accounts are not reviewed and corrected before the statute of limitations precludes the payment of the refunds. The Revenue and Taxation Code, Section 26073, states that, except for specified circumstances, no credit or refund shall be allowed or made after four years from the original or extended due date of the return or one year from the date of the overpayment, whichever is later.

In some instances, the board processed internal documents that erroneously removed credit balances from the credit follow-up file before the statute of limitations expired. By removing the credit balances, the board essentially eliminated the opportunity for taxpayers to receive these amounts as refunds unless the taxpayers request refunds before the statute of limitations expires. If the board examines or reviews a taxpayer's account and discovers that a credit balance was erroneously removed from the credit follow-up file, it can reestablish the credit balance on the file if the statute of limitations has not expired. Although the board has reviewed more than $10.3 million in credit balances that it previously removed from the credit follow-up file, it determined that more than $1.8 million of these amounts cannot be reestablished on the taxpayers' accounts because the statute of limitations has now expired.

We reported a similar weakness in our audit report for fiscal year 1988-89. As a result, the board revised its policies, implemented additional procedures to resolve specific weaknesses, and implemented system changes. The board also agreed to submit a report to the Legislature, which is discussed in more detail in the next item.

Recommendation

To resolve weaknesses in the board's examination and review of credit balances on its bank and corporation tax system, the board should take the following actions:

- Implement written procedures that require it to promptly review all credit balances on the credit follow-up file before the statute of limitations expires;

- Complete its review of the credit balances that were unresolved as of February 13, 1991, those that were sent to the board's bank and corporation audit unit for additional review, and those that were removed from the taxpayer accounts because the board did not review taxpayer accounts before the statute of limitations expired;

- Refund credit balances that it determines are tax overpayments; and

- Summarize amounts that are past the statute of limitations and include them in its report to the Legislature.

Insufficient Resolution of Identified Weaknesses in the Bank and Corporation Tax System

Finding

The board has not sufficiently resolved additional identified weaknesses in the automated system that it uses to assess, collect, and refund bank and corporation taxes. Specifically, the board has not identified all the accounts of taxpayers who should receive adjustments because of a federal court decision in the Avon Products case. In addition, the board has not adequately informed taxpayers of the calculations necessary to determine whether they could be affected by the Avon decision. Further, the board has not sufficiently addressed problems caused by its periodical purge of information from its automated corporate tax system. Finally, the board has not completed a report to the Legislature that will estimate the effect on taxpayers of various weaknesses in the board's bank and corporation tax system.

Avon Decision: As we discussed in the preceding item, the board's internal audit unit initially identified some of these weaknesses on March 28, 1989, in a draft audit report. Based on our review of the documents identified in that item, we determined that the board management's response did not sufficiently resolve certain issues related to the implementation of the Avon court decision. In 1983, the Internal Revenue Service (IRS) established its procedures to implement a federal court decision based on the case *Avon Products, Inc. v. United States (2d Cir. 1978) 588 F.2d 342* (Avon decision). The Avon decision defines the balance upon which interest should be paid so that taxpayers are charged interest for only the period when amounts are due and unpaid. A September 9, 1985, memorandum approved by the board's chief legal counsel states that, to implement this decision, the board should manually adjust taxpayers' accounts affected by the Avon decision when potentially large refunds might be made or when the taxpayers request a recomputation of interest until the necessary changes could be made to the automated bank and corporation tax system.

The study team report states that, in March 1986, the board's executive management wrote and approved new procedures to implement the Avon decision. However, the report further states that the procedures were not fully implemented, so only the taxpayers who requested a recalculation of interest received it. In response to the audit reports, the board performed an extensive review and made thousands of adjustments to taxpayers' accounts. These adjustments resulted in refunds of interest, based on the Avon decision, to more than 2400 taxpayers totaling more than $3.8 million. Another 72 taxpayers with refunds expected to be more than $8.4 million were referred to the board's bank and corporation audit unit.

Despite the measures the board has taken to address the weaknesses identified by the internal auditors, we determined that the board's procedures were not sufficient to identify some additional taxpayers whose accounts could be affected by significant adjustments that could result in refunds of interest based on the Avon decision. The board did not identify some of these taxpayers' accounts because it selected accounts for its extensive review from the board's automated file as of April 30, 1990. Those transactions that were purged from the automated file to microfiche before that date were not always included in the board's review. For example, in a sample of ten taxpayers' accounts, with interest assessments in excess of $1 million, we identified three accounts that, based on the Avon decision, should receive interest adjustments of more than $87,000. Although we informed the board of these accounts it has been slow to develop procedures to implement the Avon decision. A supervisor in the board's bank and corporation processing unit concluded that the board now cannot make the adjustments to two of these taxpayers' accounts because the statute of limitations for making these refunds has expired. The board would have posted credits to the accounts of two of these corporations, resulting in refunds of more than $38,000, if the statute of limitations had not expired. The statute of limitations for one of these taxpayers expired on September 8, 1990.

Taxpayers Not Notified: Since the board's internal auditors determined that the board did not fully implement the Avon decision, the board's executive management has attempted to notify taxpayers at large. The board placed a notice in the July 1990 issue of *Tax News* and sent a letter outlining the issues involved in the Avon decision to the Tax Executive Institute. Board officials state that they have not received any inquiries from taxpayers about the Avon decision. Nonetheless, in its November 1990 response to the internal audit report, the board's executive management stated that it is not practical to develop instructions to explain to taxpayers the complex interest calculations involving the effects of the Avon decision. In addition, when the board sends banks and corporations refunds based on the Avon decision, it does not inform them that the refunds are the result of the Avon decision. However, since the board is making substantial interest adjustments based on the Avon decision to numerous taxpayers' accounts and no taxpayers have inquired about potential Avon adjustments, it appears that the board has not sufficiently informed taxpayers of the issues or the taxpayers may not understand the Avon issues. According to the internal auditor's final report, several taxpayers who raised the Avon issue in the federal courts have not raised any concerns with state tax officials. This is in spite of the fact that, in at least one case, a corporation could receive a refund from California, based on the Avon decision, that is more than twice the amount that it sought in the federal court.

Microfiche Needs Review: We also determined that the board does not have written procedures to ensure that all payments a taxpayer makes are included in the calculation of a refund or a billing. According to a board official, before May 1989, it was a common practice to purge information from taxpayers' automated accounts before the statute of limitations expired. The information was purged to microfiche to save space on the taxpayers' automated files. Since the purged information may be critical to properly resolving taxpayers' accounts, board employees must sometimes review the microfiche to identify particular transactions. Because the board does not have a written procedure requiring employees to review the microfiche, it does not always identify certain transactions that should be considered in calculating a refund or a billing. For example, we identified one taxpayer that was underpaid more than $29,000 primarily because a payment that had been purged to microfiche was not included in the board's calculations when the account was resolved. A supervisor in the board's technical audit support unit concluded that this error cannot be corrected because, by the date of our discovery, the statute of limitations had expired. In another instance, an out-of-state board employee did not have convenient access to the purged data. Therefore, this employee did not include a taxpayer's $18,100 payment in a summary of payments and charges that the board used to make a financial settlement with the taxpayer.

The internal auditors recommended in their reports that, to the extent feasible, the board should restore the purged data to the automated masterfile. However, board management believed this proposal was not critical because it planned to implement alternative solutions. Although the board has implemented some corrective action, this corrective action does not ensure that additional transactions will not be overlooked in calculating refunds or billings, nor can it ensure that taxpayers receive the refunds they are legally entitled to receive.

Report to the Legislature: In its March 9, 1990, response to our management letter for fiscal year 1988-89, which included weaknesses identified by the internal auditors, the board agreed that it would submit a report to the Legislature by December 31, 1990. The board agreed to include in its report a summary of various categories of taxpayers and the amount of refunds and interest these taxpayers did not receive because of various weaknesses in the board's bank and corporation tax system. Although the board has not submitted the report, it plans to begin this additional review of taxpayers' accounts in July 1991. Without this report, the Legislature is not informed of additional liabilities the board may owe taxpayers. Further, this report is necessary for the Legislature to determine whether it should make exceptions to the statute of limitations because of these weaknesses.

In September 1990, the board submitted a request to the State and Consumer Services Agency for additional funds to design, develop, and implement a new bank and corporation tax system. According to board officials, this new system will resolve some of the weaknesses identified in our report and additional weaknesses identified by the internal auditors. According to a board official, in November 1990, the Department of Finance denied the board's request for additional funding. Instead, they recommended a delay in the project until resources could be redirected from the personal income tax rewrite project. The board believes this alternative will delay the implementation of a new bank and corporation tax system until at least January 1996.

Criteria

A technical advice memorandum approved by the board's chief legal counsel regarding the Avon decision states that "the board is not legally required to follow federal cases and rulings. However, whereas in California, state and federal law are in substantial conformity, courts and the Board of Equalization have traditionally afforded great weight to federal interpretations as applied to corresponding state law." The Revenue and Taxation Code, Section 21002, states that the Legislature finds that the development of understandable tax laws and taxpayers informed of those laws will improve both self-assessment and the relationship between taxpayers and government. The section also notes that it is the intent of the Legislature to promote improved taxpayer self-assessment by improving the clarity of tax laws and efforts to inform the public of the proper application of those laws. Further, Section 21005, requires the board to communicate with taxpayer groups and explain the most common errors made by taxpayers and how these errors may be avoided or corrected. The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires that the system of internal control include a system of recordkeeping procedures to provide effective accounting control over revenues and expenditures.

Recommendation

In order to resolve the weaknesses identified by the internal auditors and the additional weaknesses that we identified, the board should take the following actions:

- Complete its review of taxpayer accounts that may be adjusted because of the Avon decision and make refunds if appropriate;

- Include summary amounts for taxpayer accounts that are past the statute of limitations in the report to the Legislature;

- Determine whether an additional review of tapes of its automated file before April 30, 1990, should be initiated to identify taxpayers' accounts that may require significant Avon interest adjustments;

- Reconsider its decision not to develop instructions to explain to taxpayers the complex interest calculations involving the effects of the Avon decision;

- Clearly inform taxpayers who receive refunds of interest based on the Avon decision of the reason for the refund;

- Establish a written procedure that requires employees to review purged data when resolving taxpayers' accounts; and

- Proceed with its plan to complete its report to the Legislature, identifying certain categories of taxpayers and the refunds and interest that the board may owe them.

Failure To Resolve Deficiencies in the Data Processing System

Finding

The board has weaknesses in the Tandem data processing system that it uses to input information into its personal income tax and its bank and corporation tax systems. In March 1990, the vendor that supplied the board's data processing system completed a review of the system. The vendor's report identified numerous weaknesses in the operation of the board's data processing system. Since that date, the board has resolved numerous system weaknesses identified by the vendor. However, we identified the following areas where the board's actions have not sufficiently resolved identified weaknesses in its data processing system:

- The vendor stated that the board's procedures do not ensure that changes to its data processing system are properly authorized, adequately documented, and sufficiently tested. According to the vendor's report, "... there is a need to start from ground zero in establishing some basic methods and procedures in this area." Further, the lack of adequate documentation makes errors in the programs more difficult to locate and to correct. According to a board official, procedures to control changes to its system have been designed and are in the program development stage. The board official estimates that the programming of the change control procedures will begin in March 1991.

- The board does not use a security program installed on the system. According to a board official, if this program were appropriately used, the system would be more secure because all users would have their own passwords, which would be changed periodically. According to a board official, the security function will not be used until a second program is installed to make the security program easier to use. This second program will not work until a third program is implemented. However, the third program is not expected to be implemented until 1992.

Criteria

The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, generally accepted electronic data processing controls require procedures to document and schedule all planned changes, ensure that only authorized changes are initiated, and report planned changes to information systems management and to the users affected. Further, these controls require that only authorized, tested, and documented changes be accepted into production. Finally, these controls require that an entity issue a standard instruction requiring that security codes, such as passwords, be changed on a regular basis, and be unique to each individual.

Recommendation

The board should ensure that program development for the procedures to control changes to its Tandem data processing system are completed and implemented. The board should also make every effort to implement the security program as soon as possible.

Tax Refunds Delayed

Finding

The board does not consistently issue tax refunds promptly. Of the 96 bank and corporation tax refunds that we reviewed, the board did not process 10 refunds within the required number of days. The board is required by law to pay interest on overpayments of taxes that it does not refund within the required number of days. According to the board's senior legal counsel, the board must pay this interest even if taxpayer delays in providing information caused the refund to be late. During the 1989-90 fiscal year, the interest rate the board paid taxpayers was approximately 2.8 percent higher than the rate it received on deposits in the state treasury system; thus, late refunds caused the State to incur an unnecessary interest expense.

During fiscal year 1989-90, the board paid approximately $105 million in interest expense on approximately 108,000 refunds to bank and corporate taxpayers. Based upon the board's calculations from the prior year, the board was required by statute to pay approximately $99 million of this amount to bank and corporate taxpayers under audit who made deposits toward estimates of tax due to stop interest and penalties from accruing. Since the board receives interest on deposits in the state treasury system, we estimate that, of the remaining $6 million, the board incurred approximately $1.5 million in unnecessary interest expense because it was slow to process refunds.

We reported a similar weakness during our financial audits of the board for fiscal years 1987-88 and 1988-89. In its March 9, 1990, response to our last report, the board noted that its operational goal is to process all original returns within times that would not require the payment of interest. The board stated that it would continue its efforts to reduce the amount of interest payments that are in its operational control.

Criteria

The Revenue and Taxation Code, Sections 26080 and 26080.5, requires the board to pay interest on overpayments of bank and corporation taxes that it has not refunded within 90 days after the due date of the return or the date the return was filed, whichever is later.

Recommendation

The board should continue its efforts to ensure that it issues tax refunds promptly before interest begins to accrue.

Lack of Documentation To Support Adjustments to Taxpayers' Accounts

Finding

The board is not always able to provide documentation to adequately support adjustments that it makes to certain taxpayers' accounts. We found the following specific examples of the lack of documentation:

- The board is unable to provide sufficient documentation to support the cancellation of a penalty for more than $348,000 that it posted to a corporate taxpayer's account. The nonremit extension request to support the cancellation of the penalty was destroyed. In addition, according to one of the board's procedure manuals, the board's policy is to destroy all nonremit extension requests as soon as it has posted the necessary information to the taxpayers' accounts. However, without these documents, the board is unable to provide assurance that the penalties were properly cancelled.

- The board could not locate one of the 33 corporate files that we requested to review. The missing corporate file should contain documents to support a penalty assessment of more than $243,000. Since it cannot locate the file, the board is unable to provide assurance that this penalty is correctly calculated and properly assessed.

- The board could not locate the documentation to support three of the ten personal income tax refunds that we requested for a special review. The missing documents should support refunds that total more than $120,000. Since it cannot locate the documentation for these refunds, the board is unable to provide assurance that these personal income tax refunds are correctly calculated and properly supported.

Criteria

The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires that the system of internal control include a system of recordkeeping procedures to provide effective accounting control over revenues and expenditures. The State Administrative Manual, Section 1667, requires agencies to consider audit requirements when making decisions for document retention periods. In addition, Section 1671 recommends a retention period of at least two years, or until audit, for many fiscal records.

Recommendations

The board should review its controls over the filing and checkout of documents and taxpayer files. It should also revise its policy to ensure that documents are maintained at least until an audit is completed.

Potential Liabilities Not Disclosed

Finding

The board did not include several significant potential liabilities in its representation letter to the Department of Finance. Specifically, the board did not include court cases being litigated by the state attorney general that may result in liabilities to the State of $500 million for one issue and $10 million for a second issue. Also, it did not include a potential liability, related to on-going litigation, that may total $100 million. This potential liability was discussed at meetings of the Franchise Tax Board.

The board believes that it is not required to include these potential liabilities in its representation letter. The board bases this opinion on its interpretation of a section of the State Administrative Manual that requires the board to account for tax refunds on the cash basis. However, a different section requires the board to disclose material potential liabilities, and this section does not limit the disclosure for cash basis funds. This disclosure is critical because, without disclosure of material potential liabilities, the Department of Finance cannot provide this information to the auditor general, who is responsible for issuing an audit opinion on the State's financial statements. Thus, without the disclosure, the State's financial statements and the related notes may provide misleading information to Department of Finance officials and to the financial community.

Criteria

The State Administrative Manual, Section 20007, requires agencies to submit a representation letter to the Department of Finance. The letter must include disclosure of material loss contingencies that are required to be accrued or disclosed by the Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies." This statement requires disclosure of losses when there is a reasonable possibility that a loss occurred. This disclosure must describe the nature of the loss contingency and an estimate of the possible loss. The statement also notes that pending litigation is an example of a loss contingency.

Recommendation

The board should ensure that it includes all material potential liabilities in its representation letter to the Department of Finance.

Late Notification of Employee Embezzlement

Finding

The board was more than four months late in submitting a required report of employee embezzlement to the Office of the Auditor General. According to the board's report, on July 20, 1990, the board began an investigation of an employee suspected of embezzling funds from the board. However, the board did not provide a report of its investigation or its findings to the Office of the Auditor General until November 28, 1990. Since the report includes an explanation of the controls that were circumvented by the employee, the delay in notification hinders the Office of the Auditor General's ability to promptly review the circumvented controls.

Criteria

The State Administrative Manual, Section 0600, requires agencies to notify the Office of the Auditor General of all cases of actual or suspected theft or irregularity. The section further requires that, if complete information is not available, the agency must give preliminary notification by the first business day following the discovery. Finally, the section requires that, if complete notification is not made within 30 days, the agency must submit a progress report every 30 days until notification is complete.

Recommendation

The board should comply with the procedures in the State Administrative Manual by submitting any future reports within the required timeframes.

Lack of Documentation To Support Financial Statement Account Balances

Finding

The board could not provide documentation to support the balances of its "cash on hand" accounts in some of its financial statements. Specifically, the board could not provide an audit trail for approximately $8.9 million in the cash on hand account for the Personal Income Tax Fund and approximately $6.0 million in the cash on hand account for the Bank and Corporation Tax Fund. According to a board official, during fiscal year end, it is a time-consuming and costly process to separately batch prior year and current-year remittances to maintain the audit trail. However, unless the audit trail is maintained, we have no assurance that, at June 30, 1990, the cash on hand accounts in these two funds were fairly stated.

Criteria

The Government Code, Section 13402, requires agencies to maintain an effective system of internal accounting and administrative control. In addition, Section 13403 requires agencies to ensure that a satisfactory system of internal accounting and administrative control include a system of recordkeeping procedures to provide effective accounting control over assets, liabilities, revenues, and expenditures. In addition, the State Administrative Manual, Section 7951, requires all agencies to retain the detail to support general ledger account balances as of June 30 for use by auditors of the Department of Finance and the Office of the Auditor General.

Recommendation

The board should maintain all necessary documentation to support all general ledger accounts at June 30. If the board believes that developing and maintaining an audit trail is not cost effective, it should apply to the Department of Finance for a waiver from these requirements.

Delayed Collection of Travel Advances

Finding

The board did not promptly collect outstanding travel advances from the revolving fund. We reviewed 30 advances outstanding as of June 30, 1990, and found that the board had not cleared 4 travel advances totaling $3,707 as of November 13, 1990. Delayed clearance of revolving fund advances could result in the loss of state funds if employees leave state service without repaying the advance.

Criteria

The State Administrative Manual, Section 8116, requires that, if the advance exceeds the employee's travel expense voucher, the employee must reimburse the revolving fund for that difference promptly, unless the employee will travel in the near future. In addition, the board's General Procedure Manual, Section 9500.1(4), states that expense claims must be submitted at least once a month.

Recommendation

The board should promptly clear all revolving fund advances.

Department of General Services

We reviewed the financial operations and related internal controls at the Department of General Services (department).

Possible Liability to the Federal Government

Finding

The Department of General Services (department) has a possible liability to the federal government estimated to be as much as $8.4 million for profits it has accumulated in its Service Revolving Fund (SRF) between July 1, 1984, and June 30, 1990. The department's SRF is an internal service fund that provides printing and procurement services to state agencies. The SRF charges state agencies for services it provides. In turn, state agencies have passed these charges on to federal programs that the agencies administer. When the SRF's charges exceed its costs for providing the services, the department accumulates profits in its SRF. Federal regulations prohibit the State from charging federal programs for more than its costs.

In 1984, the federal Department of Health and Human Services audited the State's rate-setting methods for internal service funds. As a result of the audit, the State was required to refund to the federal government approximately $14.9 million of the profits accumulated in internal service funds. This amount represented the federal share of profits accumulated in five of the State's internal service funds during the period July 1, 1969, to June 30, 1984. The Department of Finance calculated that 15.5 percent of the SRF's accumulated profits of approximately $66.8 million at June 30, 1984, resulted from charges to federal programs and, thus, determined that the amount that the SRF owed to the federal government was approximately $10.3 million.

Using procedures similar to those of the Department of Finance, and using the same ratio of 15.5 percent, we estimate that, under current federal regulations, the State may owe the federal government approximately $8.4 million. This is the federal share of profits accumulated by the SRF during the period July 1, 1984, through June 30, 1990, after audit adjustments that increased accumulated profits by $10.6 million. However, an October 1988 proposed amendment to the federal Office of Management and Budget, Circular A-87, would allow state agencies a reasonable working capital reserve of 60 days worth of cash expenditures. This amendment, if approved, would decrease the amount owed to the federal government to approximately $1 million.

However, the department may not be able to reimburse the federal government for any potential liability because the SRF's fund balance may be reduced to the point that it does not have sufficient working capital to operate. The budget act for fiscal year 1989-90 required that the State transfer from the department $12 million on June 30, 1990. Further, Section 1760-031-666 of the 1991 Budget Act, requires the department to transfer an additional $15.3 million of the SRF's profits to the State's General Fund on June 30, 1991. Additionally, the SRF accumulated profits totaling approximately $2.7 million in its building rental account. This accumulation occurred because the department established its rental rates to pay for special repair projects on state-owned buildings. However, based on a recommendation of the Office of the Legislative Analyst, the department did not perform the repair projects, and it did not reduce the rental rate accordingly. Instead, the budget acts for fiscal year 1989-90 and 1990-91 required that the department transfer the accumulated profits to the General Fund. These combined transfers will reduce the department's working capital to $17.2 million if the department does not accumulate additional profits during fiscal year 1990-91. This amount is not enough to cover 30 days of its cash expenditures.

Since the federal government and the State's executive branch are ultimately responsible for negotiating any final settlement, we did not attempt to determine whether the percentage of federal participation that the federal government accepted in its 1984 audit is still acceptable in 1990. Also, because the SRF does not record compensated absences and worker's compensation in its accounts, we did not attempt to adjust for these liabilities, even though the increased accumulated profits should be adjusted for these liabilities.

While the department is in compliance with state laws regarding its accumulation of profits in the SRF, it is not in compliance with federal regulations. This condition exists because the Department of Finance and the department have not ensured that charges to federal programs are in compliance with federal regulations.

We reported a similar finding during our financial audit for fiscal year 1988-89. We recommended that the Department of Finance develop guidelines that would ensure that state agencies that receive services from the department exclude amounts that exceed allowable costs when charging federal programs. In his response of March 16, 1990, the Director of Finance stated that he planned to address the issue of setting rates for internal service funds once the Office of Management and Budget decides on the amendments to Circular A-87, "Cost Principles for State and Local Governments."

Criteria

The federal Office of Management and Budget, Circular A-87, "Cost Principles for State and Local Governments," does not allow the State to charge federal programs for amounts that exceed costs. In addition, the California Government Code, Section 13070, provides the Department of Finance with general powers of supervision over all matters concerning the financial and business policies of the State.

Recommendation

The department should comply with the federal Office of Management and Budget, Circular A-87, when establishing billing rates for charges to state agencies that receive federal support. Further, the Department of Finance should ensure that the department complies with federal regulations. For example, compliance could be ensured by developing guidelines for the department and state agencies that receive services from the department. In addition, the Department of Finance should monitor the proposed amendment to Circular A-87 to determine the effects that the amendment may have on state charges to federal programs.

Failure To Transfer Interest Collected From School Districts to the General Fund

Finding

The Office of Local Assistance (OLA) did not request that the State Controller's Office transfer to the State's General Fund approximately $31.8 million in interest during fiscal years 1981-82 through 1989-90. The OLA stated that it did not ask the State Controller's Office to transfer the interest because it was following a State Allocations Board policy that states that the OLA may apply the interest to the cost of the project. However, according to an opinion we received from the Legislative Counsel, the board is not authorized to apply the interest to the cost of the project instead of transferring the interest to the General Fund. (We also cited this condition in our report dated January 30, 1991, "Some School Construction Funds Are Improperly Used and Not Maximized.")

The OLA provides grants to school districts for construction projects under the lease-purchase program. Frequently, the OLA disburses the grant monies to a school district before the school district actually begins the construction project. In turn, school districts deposit the monies into their county treasuries' interest-bearing accounts. The Education Code directs the State Allocation Board, which is the governing authority for the OLA, to collect rents from districts. The Education Code also states that these rents shall not exceed the sum of four items, which includes the amount of interest earned on funds that the school districts receive under the lease-purchase program. Further, the Education Code requires that the interest collected should be transferred to the General Fund to reimburse the General Fund for funds paid to redeem school construction bonds.

In 1980, the State Allocation Board adopted a regulation that rental payments may take the form of a contribution toward the cost of an ongoing project or take the form of a direct remittance. Following this State Allocation Board policy, the OLA's practice has been to notify the school districts when it intends to treat the interest earnings as contributions toward the costs of the school districts' on-going projects. The OLA prepares administrative journals, which it uses to inform the school districts and the State Controller's Office that it has applied the interest towards the cost of construction projects. This transaction has the effect of collecting the interest because it reduces the amount the OLA would eventually pay the school district for the construction project. Because it does not actually receive the interest for deposit into the lease-purchase funds but chooses, instead, to apply the interest towards the cost of the construction projects, the OLA's position is that it is not required to transfer this interest to the General Fund.

We asked the Legislative Counsel to review the issue and determine whether the OLA, acting according to State Allocation Board policy, has the authority to apply a district's interest earnings toward the cost of the district's school construction project. The Legislative Counsel's opinion stated that the intent of relevant legislation was not to make the transfer of the interest dependent on whether the State Allocation Board chooses to apply the interest to the cost of a project or receive a direct remittance from the school district. Instead, according to the Legislative Counsel, the intent of the law is to require that those interest payments be transferred to the General Fund. The Legislative Counsel, therefore, concluded that the OLA, acting according to the State Allocation Board policy, is not authorized to apply rent payments toward the cost of school construction projects.

Since 1982, the OLA has informed the State Controller's Office of more than $18.4 million in interest from school districts through its preparation of administrative journals. However, none of this interest has been transferred to the State's General Fund. We also found approximately $13.4 million in interest for which the OLA had not prepared administrative journals. Therefore, the State Controller's Office probably was not notified of the additional interest. As a result, the State's General Fund has paid at least $31.8 million more than it should have to redeem school construction bonds because the interest was not transferred to the General Fund. The State Controller's Office had not transferred the interest but, when we brought this requirement to their attention, the State Controller's Office recorded a liability in the appropriate lease-purchase funds and a receivable in the General Fund totaling approximately $31.8 million on its June 30, 1990, financial statements. Additionally, the State Allocation Board is currently reviewing the issue.

Criteria

The Education Code, Section 17732, directs the State Allocation Board to collect rents from school districts participating in the lease-purchase program. Section 17732 also states that the amount of rent that the State Allocation Board collects from a district shall not exceed the sum of four items, which includes the amount of interest earned by the district in the district's lease-purchase fund. Further, the Education Code, Sections 17685, 17695.3, 17696.3, 17697.30, and 17698.30, states that all money deposited in the lease-purchase funds pursuant to Section 17732 must be available only for transfer to the State's General Fund to reimburse the General Fund for funds paid to redeem school construction bonds. Finally the Education Code, Section 17708.5, states that no disbursement shall be made from any funds required by law to be transferred to the State's General Fund.

Recommendation

The OLA should comply with the Education Code and request the transfer to the General Fund interest earned on school districts' deposits.

Inadequate Controls Over Accounting Records

Finding

The department's Office of Local Assistance (OLA) maintained inadequate controls over its accounting records for the State School Building Lease-Purchase Fund (fund 344) and the School Facilities June 1988 Bond Account, State School Building Lease-Purchase Fund (fund 789). We reported similar weaknesses during our audit for fiscal years 1987-88 and 1988-89. We identified the following deficiencies:

- The records in which the OLA records expenditures and remaining spending authority for fund 344 do not agree with similar records maintained by the State Controller's Office. Although the OLA maintains listings of differences between the OLA and the State Controller's Office, the OLA has not evaluated these listings to determine which records are in error. The OLA and the State Controller's Office began to correct some of these errors during fiscal years 1988-89 and 1989-90; however, the records of the OLA and the State Controller's Office continue to reflect a difference of approximately $8 million. These differences occurred because in past fiscal years, the OLA and the State Controller's Office had recorded transactions incorrectly and the OLA had failed to bring the errors to the attention of the State Controller's Office.

- The OLA's subsidiary project cards, which document the detailed funding history of each project, do not reconcile with expenditure totals posted to the general ledger for each project. We found that for 35 of 108 projects we tested, the OLA did not record in its general ledger certain grant awards and did not record all grant payments that had been cancelled. The OLA had not previously identified these recording errors because it does not reconcile its subsidiary project cards with its general ledger account balances. As a result, the account balances at June 30, 1990, were incorrect. For example, the due to local governments account for fund 789 was understated by approximately $1.3 million, the due to local governments account for fund 344 was overstated by approximately

$29.2 million, and the due from local governments account for fund 344 was overstated by approximately $22.3 million. When we brought this to their attention, the OLA corrected its general ledger and submitted corrections to the State Controller's Office for the errors in fund 789 and for the errors in the due from local governments account for fund 344. Additionally, the department corrected approximately $25.9 million of the errors we identified in the due to local governments account for fund 344. Finally, according to an audit manager from the Department of Finance, the OLA is currently in the process of contracting with the Department of Finance to assist the OLA with the backlog of project card reconciliations.

Because the OLA had not reconciled its accounting records and corrected errors, the OLA was not aware that it had exceeded its spending authority for fund 344. The department's total commitments to school districts at June 30, 1990, was approximately $150 million. However, the funds available in fund 344 to meet the commitments totaled approximately $131 million.

Criteria

The State Administrative Manual, Section 7800, requires subsidiary ledgers to be reconciled with the general ledger each month. Additionally, the State Administrative Manual, Section 7900, discusses the importance of making regular reconciliations. Properly prepared reconciliations represent an important element of internal control because they provide a high level of confidence that the transactions have been adequately recorded and that the financial records are complete.

Recommendation

The OLA should promptly evaluate and correct any posting differences between its records and the records of the State Controller's Office. Additionally, the OLA should reconcile its subsidiary project cards with its general ledger every month.

Incorrect Year-End Financial Reports

Finding

The Office of Local Assistance (OLA) did not correctly prepare its financial reports for the State School Building Lease-Purchase Fund (fund 344), the School Facilities November 1988 Bond Account, State School Building Lease-Purchase Fund (fund 776), and the School Facilities June 1988 Bond Account, State School Building Lease-Purchase Fund (fund 789). We found various inconsistencies in the preparation of the financial reports for these funds and material misstatements of account balances. We identified the following errors:

- The OLA incorrectly recorded as expenditures an adjustment to the agency's spending authority on the Report of Adjustments to the Controller's Account for fund 776. The OLA should not have reported this type of transaction on this report. As a result, in fund 776, the State Controller's Office incorrectly established a liability account and overstated the expenditure account by approximately $75 million.

- The OLA incorrectly prepared the Report of Accruals, and it did not completely prepare the Report of Adjustments to the Controller's Accounts for fund 344. As a result, the State Controller's Office incorrectly recorded approximately $6.1 million as transfers in when, instead, it should have recorded $3.6 million as due to other funds and $2.5 million as due to local governments.

- The OLA did not completely prepare the Report of Adjustments to the Controller's Accounts for fund 789. As a result, the State Controller's Office incorrectly recorded $576,000 in expenditures as due from local governments.

These errors occurred because the accounting staff did not understand how to prepare the financial reports. When we brought this to their attention, the department submitted corrections to the State Controller's Office.

Criteria

The State Administrative Manual, Sections 7950 through 7956, illustrates the correct presentation and use of the State's financial reports.

Recommendation

The OLA should ensure that its staff understands how to prepare the department's financial reports. In addition, the appropriate supervisorial staff should review the financial reports to ensure the accuracy of the reports.

Insufficient Accountability Over Fixed Assets

Finding

The department's Office of Local Assistance (OLA) did not maintain sufficient control over fixed assets in the State School Building Aid Fund. During our audit for fiscal year 1989-90, we identified the following conditions:

- The OLA did not follow the State's guidelines for recording the acquisition of fixed assets. Specifically, the OLA recorded purchases that cost less than $500 each in the records for fixed asset equipment. Equipment recorded in the records for fixed assets is known as capitalized equipment and must have a unit acquisition cost of at least $500. In addition, the OLA recorded as a fixed asset the costs of storing portable classrooms. However, unless costs are incurred to put the classrooms in condition for their intended use or the costs are incurred to purchase the classrooms, they should not be recorded as fixed assets. These kinds of weaknesses can result in an overstatement in the fixed asset account balance.

- The OLA did not perform monthly or quarterly reconciliations of fixed asset expenditures with the fixed asset ledger system (property ledger) during fiscal year 1989-90. While the OLA's general ledger showed total fixed asset expenditures during fiscal year 1989-90 of approximately $7.8 million, the property ledger showed an increase in fixed assets of approximately

> $10 million for the same period. In addition, the OLA has not completed its reconciliation of fixed asset expenditures for prior years. We also reported this weakness in fiscal year 1988-89. The OLA stated in its corrective action plan, dated April 23, 1990, that it would prepare monthly reconciliations of current-year fixed asset expenditures and would complete reconciliations of prior year expenditures by January 1992. Unless these reconciliations are prepared, the fixed asset information in the property ledger is unreliable.

The OLA's failure to maintain sufficient control over fixed assets prevents the prompt detection of errors.

Criteria

The State Administrative Manual, Section 8602, states that capitalized assets must have a unit acquisition cost of at least $500. In addition, the State Administrative Manual, Section 8612, states that capitalized building costs include the purchase price plus other costs incurred to put the building in condition for its intended use. Finally, the State Administrative Manual, Section 7969, requires that expenditures be reconciled monthly or quarterly, depending on the number of property transactions, with the property ledger.

Recommendation

The OLA should state guidelines when recording fixed asset acquisitions. In addition, the OLA should perform monthly reconciliations of expenditures between its general ledger and the property ledger to identify any errors or omissions from the fixed asset account balance. Finally, the OLA should complete its reconciliation of fixed asset expenditures for prior years.

Inaccurate Analysis and Reporting of Payables and Encumbrances

Finding

The Office of Local Assistance (OLA) did not accurately analyze and report its payables and encumbrances at June 30, 1990. Payables represent obligations for goods and services received at June 30. Encumbrances represent commitments for goods and services to be received after June 30. The OLA incorrectly reported to the State Controller's Office approximately $6.1 million as payables rather than encumbrances, even though these items represented goods or services not yet received at June 30, 1990. Failure to analyze and report payables and encumbrances accurately to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately and in accordance with generally accepted accounting principles. When we brought this to their attention, the OLA submitted a correction to the State Controller's Office.

Criteria

The State Administrative Manual, Section 10544, requires agencies to analyze their obligations and encumbrances as of June 30 and to determine whether they received the goods and services before or after June 30.

Recommendation

The OLA should analyze its commitments to determine whether it received the goods and services before or after June 30, and it should appropriately report to the State Controller's Office amounts owed as payables or encumbrances.

Lack of Procedures For Collecting Amounts Owed By School Districts

Finding

The Office of Local Assistance (OLA) does not have procedures for collecting amounts that school districts owe to the State School Building Lease-Purchase Fund. As discussed in Item 2, a school district may earn interest on grant awards received from the OLA. The OLA usually records the interest as revenue and applies the interest towards the cost of the school district's construction project. However, if the OLA has disbursed the full grant award to the school district, it requests that the school district submit the interest earnings to the OLA, and the OLA establishes a receivable. Additionally, a receivable may be established when a school district owes the OLA a reimbursement for a portion of its original grant award because of audit exceptions or other errors made during the payment process. We found that the OLA has not established procedures for collecting delinquent receivables from the school districts. Approximately $1.0 million of the $2.9 million of receivables that we tested had been outstanding for two to four years. Approximately $500,000 of these receivables are ultimately due to the General Fund. Failure to develop collection procedures may result in some receivables becoming uncollectible.

Criteria

The State Administrative Manual, Section 8710.1, requires each state department and agency to develop collection procedures that will ensure prompt collection.

Recommendation

The OLA should develop procedures for prompt collection of its receivables.

Weaknesses in Accounting for the Telecommunications Division's Inventory

Finding

Procedures of the department's Telecommunications Division (division) do not ensure that the department accurately records or reports its inventory. For example, written instructions that the division provides to staff who are performing the inventory count are incomplete. In addition, the staff does not always follow the instructions. Furthermore, the division's method of pricing inventory in the area shops and the central store does not result in a recorded value that reflects the actual costs of the inventory on hand. We also found that a new inventory system that the division used to price its central store inventory does not maintain a purchase history file. Finally, the division does not reflect in its inventory balance at June 30 transactions between the date of the inventory count and June 30. As a result, the $1.3 million balance that the department reported may not accurately reflect the value of the division's inventory at the end of the fiscal year. We reported similar weaknesses during our financial audit for fiscal years 1987-88 and 1988-89.

After its staff counts and prices the annual physical inventory, the division notifies the accounting office of the new inventory balance. Using this information, the accounting office records the change from the previous year's balance. Because the department does not have a system that informs the accounting office of changes in the inventory account throughout the year, the accounting office relies entirely on the accuracy of the division's inventory balance for the amount that it reports in the financial statements for the Service Revolving Fund. However, we have the following concerns regarding the process that the division used to compute the inventory balance:

- The division's written instructions for the inventory count do not state that, during the inventory count, staff should not have access to the inventory balances in the detail records. In addition, the division's written instructions do not direct staff to investigate differences between detail inventory records and inventory counts after the inventory count has been completed. Furthermore, during the division's inventory count of area shop three, the shop manager did not restrict the removal of inventory during the count. The division included inventory in the inventory balance at June 30, 1990 that staff believed was removed during the count.

- The division's method of pricing does not result in a recorded value that reflects the actual cost of the inventory on hand. During fiscal year 1989-90, the division implemented a new inventory system for its central stores inventory that calculates a value for each inventory item based on the item's average purchase price. Because the purchases are entered into the system from the purchase orders, the unit prices used to calculate the average purchase prices do not include sales tax, freight, and vendor discounts. Additionally, for the area shops' inventories and the beginning values entered into the new system for the central store's inventory, the division continues to price all like-items at the same value even though the items may have been purchased at different prices. The division bases these prices on manufacturer's price books and phone quotes rather than actual costs. We tested the recorded values for 45 inventory items. For 17 items, we calculated the average purchase price based on the most recent purchase and compared it to the average price in the inventory system. We found differences greater than 5 percent for 14 of these items. For an additional 8 items, we were unable to conclude that the inventory values were reasonable because the division did not make any purchases for these items during fiscal year 1989-90 and we could not match the unit price that the division used with the previous year's unit price.

- During July and August 1990, the division discontinued maintaining a file that includes purchase information for each item in inventory. As a result, for the fiscal year 1990-91 audit of inventory, we will be unable to track purchases to determine whether the average unit prices included in the inventory system are correct. After we brought this to their attention, a manager stated that the division began to maintain this information during September 1990.

- The accounting office changes the inventory account balance only after a physical inventory. Because the inventory was taken during the first week of June, the balance recorded as of June 30, 1990, actually reflected the status of the inventory three weeks earlier.

Criteria

The California Government Code, Section 13401, requires agencies to maintain an effective system of internal control. In addition, the Government Code, Section 13403, requires that the system of internal control include recordkeeping procedures sufficient to provide effective accounting control over assets, liabilities, revenues, and expenditures. Further, generally accepted accounting principles prescribe that inventories be valued at the cost of acquiring the inventories.

Recommendation

The department should ensure that the division's written instructions for the inventory count are complete. The department should also ensure that the division correctly reports its inventory balance. Additionally, the division should use a consistent, documented method of pricing inventory that causes the recorded inventory to reflect the acquisition costs. Further, to ensure that the inventory values can be audited, the division should continuously maintain its purchase file. Finally, to ensure that the amount reported in the financial statements reflects the value of the inventory at June 30, the division should analyze transactions occurring during the period between the physical inventory and the end of the fiscal year.

Improper Accounting for Equipment; Duplication of Effort

Finding

The department does not include in its equipment account all costs to acquire, install, and prepare equipment for its intended use. Additionally, the department does not include in its inventory the components and parts that are designated for use in constructing telecommunications equipment. Finally, the department maintains duplicate systems to account for its telecommunications equipment. We noted the following weaknesses:

- Telecommunications or microwave equipment comprises a variety of components that when assembled, make the microwave equipment functional. However, rather than account for the assembled equipment as one asset that would include all components used in the construction of the asset, the department records separately in its equipment account each component having a cost of more than $500. As a result of recording each component separately, the department does not include in its equipment asset accounts any microwave components that cost less than $500, even though these components are part of the initial cost of preparing the microwave system for use. Instead, the department expenses these items. As a result, the department is understating its equipment accounts and overstating its expense accounts in the year it purchases equipment.

- Further, the department has yet to place into service some of these same microwave components costing less than $500. The department may store these components in its warehouses for as long as three years, but it does not account for these components in either its inventory or equipment accounts because the department has already expensed these items when purchased. As a result, the department does not account for these stored components through a physical inventory that could detect the loss or theft of state property.

- Both the Telecommunications Division and the Office of Fiscal Services of the department are maintaining records for the microwave equipment. Both property systems seem to maintain the same information and in order to update both systems the department enters the same information twice. When staff time is duplicated to perform the same procedure, the department does not operate efficiently.

Criteria

The State Administrative Manual, Section 8602, allows departments that purchase property with proprietary funds to establish their own capitalization requirements with the approval of the Department of Finance. Accordingly, the department issued Administrative order 86-5 as its policy for the capitalization of fixed assets. This policy states, "Some assets are acquired in stages, such as the purchase of components which are assembled to make up an asset (e.g., EDP equipment). The total cost of the components will be used for asset capitalization purposes. The rationale is that the cost of the asset should include all components which are required to make the asset operate as intended."

Additionally, the California Government Code, Section 13403, requires that internal accounting and administrative controls include methods that promote operational efficiency and encourage adherence to prescribed managerial policies.

Recommendation

The department should properly record the cost of all microwave components used in assembling microwave systems. Additionally, the department should determine which of the two systems for accounting for telecommunications' equipment is the most accurate and efficient and then use only that system.

Delays in Returning Unencumbered Balances in the Architecture Revolving Fund

Finding

As in previous fiscal years, the department has not always returned unencumbered funds to depositing agencies within the time required by the California Government Code. Delays in returning unencumbered balances to the depositing agency delay the availability of the funds for appropriation by the Legislature.

The Legislature appropriates funds for construction projects from the funds of agencies that will benefit from the projects. The agency receiving the appropriation then transfers the funds to the Architecture Revolving Fund (ARF). Within three months after the project is completed or within three years after the initial transfer of the funds, the department is required to return any unencumbered balances to the agency that received the original appropriation.

We reviewed 41 completed projects to determine if the department promptly returned unencumbered funds to agencies. For 16 of the 41 projects, the department took over three months to three years to return unencumbered funds of the completed projects. In 3 of the 16 instances, the department requested the return of funds within the required three months. However, the State Controller's Office and the Department of Finance took up to six months to process the request.

Further, the department does not always return unencumbered funds within three years from the time the funds are originally transferred to the ARF. The department did not return unencumbered funds on time for 17 of 34 projects we reviewed for which funds were transferred to the ARF before June 30, 1987. The department was up to six months late before it returned the unencumbered funds for 9 of the 17 projects. For 4 of these 9 projects, the department requested the return of funds within the required three years. However, the State Controller's Office and the Department of Finance took approximately one to two months to process the requests. For the remaining 8 projects, the department has not yet processed the return of funds or obtained the approval of the Department of Finance to retain the funds for more than three years.

During our financial audits of the department for the last six fiscal years, we reported similar delays in returning unencumbered funds within the three-month limit. Additionally, for fiscal years 1986-87, 1987-88, and 1988-89, we reported similar delays in returning unencumbered funds within the three-year limit. The department implemented procedures in March 1987 to reduce delays in returning unencumbered balances.

Criteria

The California Government Code, Section 14959, requires the department to transfer unencumbered balances of the Architecture Revolving Fund to the original appropriation within three months after the project is completed or within three years from the time that the funds were originally transferred to the Architecture Revolving Fund whichever is earlier.

Recommendation

The department should ensure that it returns unencumbered balances within the time limits required by the California Government Code.

Insufficient Controls Over and Incorrect Accounting for Receivables of the Architecture Revolving Fund

Finding

The department does not have sufficient controls over amounts that other agencies owe to the department's Architecture Revolving Fund (ARF), and it overstated its receivable account by approximately $32 million. The department, through its ARF, provides construction project services to various state agencies. Agencies normally transfer the funds to the ARF to pay for the services before receiving the services. However, some agencies have received approval from the Department of Finance to transfer funds to the ARF after it receives the department's services. In these situations, the department either bills the agencies, or, if the construction project is funded by bond monies, it submits requests to the State Controller's Office to transfer the money. We found that the department did not always promptly bill for services or request the transfer of funds. In addition, some agencies owe the department money because the department provided services that cost more than the original transfer of funds. We found that the department did not always resolve or investigate the collectibility of funds when the cost of services provided to an agency exceeded the original transfer of funds. We reported similar weaknesses during our audit for fiscal year 1988-89. We found the following specific conditions:

- The department recorded as receivables the encumbrance balances for its construction projects. Encumbrances are purchase orders or contracts with private vendors for goods or services that have not been received at June 30. The department enters into purchase order and contract agreements for various goods and services that will be provided after June 30. However, at June 30, the department incorrectly recorded these agreements as receivables. The department records a payable when it actually receives the goods and services, and only at that time should the department record the related receivable. Because it included in its receivable account, amounts for goods and services it had not yet received, the department overstated the ARF's receivable balance at June 30, 1990 by approximately $32 million. When we brought this to their attention, the department submitted a correction to the State Controller's Office.

- The department does not always bill for services promptly or immediately follow up on the collection of amounts owed. For example, as of September 30, 1990, the department had not billed or only partially billed agencies for 13 of 22 construction projects with receivable balances totaling approximately $5 million at June 30. In October 1990, the department billed two of the agencies not previously billed as of September 30, 1990. In one instance, the billing was for the total receivable balance as of June 30. In the second instance, the billing was for only a portion of the receivable balance as of June 30. Additionally, because the department does not always follow up on the collection of receivables it has billed, the invoices for five agencies had been outstanding for more than 90 days as of September 30, 1990.

- The department does not always promptly request that the State Controller's Office transfer monies to reimburse the ARF after the department has made payments to contractors and other vendors for construction projects funded by bond monies. In one instance, the accounting office did not request that the State Controller's Office transfer monies for payments it had made during fiscal year 1989-90 until September 10, 1990. This transfer was for one construction project totaling approximately $20 million.

- The department does not always resolve or investigate the collectibility of funds when the cost of services provided to an agency exceeds the original transfer of funds. We identified 132 projects, totaling approximately $1.5 million, that the department included on both its June 30, 1989, and June 30, 1990, financial statements. During fiscal year 1989-90, the department continued to charge expenses totaling approximately $300,000 to 30 of these projects even though the department had not taken any action to collect or resolve these outstanding receivables.

As a result of not promptly billing for and collecting amounts owed to it, the department's control over its receivables is diminished, thus increasing the risk that some receivables will become uncollectible. Additionally, the amounts outstanding are not available for use on current construction projects.

Criteria

The State Administrative Manual, Section 7620, describes receivables as amounts due for goods or services provided. In addition, the State Administrative Manual, Section 8776.3, requires that agencies prepare and send an invoice as soon as possible after recognition of a claim. Further, the State Administrative Manual, Section 8710.1, requires each department to develop collection procedures that will ensure prompt follow-up on receivables. Finally, the State Administrative Manual, Section 8776.2, requires the department to report as receivables at June 30 only receivables that the department estimates that it will collect within the following fiscal year.

Recommendation

The department should include in its receivable balance only amounts owed for goods or services provided to state agencies at June 30. In addition, the department should promptly bill or request the transfer of funds for costs of construction project services. Finally, the department should promptly resolve and investigate the collectibility of long-outstanding project receivables and adjust its receivables account accordingly.

Inaccurate Reporting of Liabilities in the Architecture Revolving Fund and the Service Revolving Fund

Finding

The department did not properly analyze and report some of the liabilities in the Architecture Revolving Fund (ARF) and the Service Revolving Fund (SRF). We found the following specific conditions:

- In total, the department understated its liabilities for the ARF by a net amount of approximately $71,000. The department did not identify approximately $437,000 owed to contractors for construction services received before June 30, 1990, and it incorrectly included in its liabilities approximately $366,000 that represented services not received until July and one invoice that had already been paid before June 30, 1990.

- The accounting unit of the Office of State Printing overstated its liabilities for the SRF by approximately $176,000. The largest error occurred because the accounting unit entered an adjustment that incorrectly increased liabilities by approximately $68,000 when the adjustment should have reduced liabilities by this amount. This error resulted in an overstatement of approximately $136,000. The remaining errors occurred because the accounting unit failed to remove, from its liabilities, invoices that it had already paid before June 30 and contracts with no outstanding payments that it had closed by June 30.

- The department incorrectly identified in its ARF approximately $1.1 million as accounts payable when it should have classified this amount as due to other funds. Additionally, the department incorrectly classified 18 items in its SRF totaling approximately $739,000 as accounts payable when it should have classified these items as due to other funds or due to other governments. The misclassification of 7 of these items in the SRF occurred because the SRF accounting unit identifies each of its cost allocation codes as an accounts payable or a due to, and it classifies the amounts included under each code accordingly. Some of these items recorded in the same allocation code could be an accounts payable or could be a due to. This method does not take into consideration who will actually be paid for the goods or services under each code.

Failure to analyze and report liabilities accurately to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately. When we brought these errors to their attention, the department submitted corrections to the State Controller's Office.

Criteria

The State Administrative Manual, Section 10544, requires state agencies to review their records to ensure that they have accurately recorded all amounts owed to others. In addition, the State Administrative Manual, Section 7630, requires state agencies to report amounts payable to other state agencies as "Due to other Funds."

Recommendation

The department should analyze all documents available to identify and record its liabilities accurately. Additionally, the department should not include amounts owed to other state agencies in its accounts payable balance at year-end.

Lack of Compliance With the Department's Collection Procedures

Finding

The department's Office of Fiscal Services, Accounts Receivable Unit, did not follow its collection procedures for outstanding receivables of the Service Revolving fund. We reviewed 29 invoices that accounted for approximately $1.9 million of the $6 million balance in outstanding receivables over 180 days old at June 30, 1990. We found that the accounts receivable unit of the department failed to send first, second, or third collection letters to the agency that it had previously billed. The invoices ranged in age from 12 to 98 months and were for as much as $398,000. A manager of the Office of Fiscal Services stated that a backlog of aged receivables was created in the receivables unit because of staff vacancies, turnover, and a lack of training for new employees. The manager also stated that the department has taken steps to reduce the backlog, including creating an accounting administrator I position to oversee the accounts receivable unit. Failure to promptly follow up on outstanding accounts receivable may result in some receivables becoming uncollectible and the loss of revenue for the department.

Criteria
The State Administrative Manual, Section 8710.1 requires each department to send a sequence of three collection letters to a debtor in an effort to collect funds owed. Additionally, the department's procedures require that collection letters be sent when an invoice is outstanding for three, five, and seven months.

Recommendation
The department should follow its collection procedures and promptly investigate and resolve long-outstanding receivables.

Failure To Investigate Large Deposits-in-Transit

Finding
The Office of State Printing (OSP) did not investigate large deposits-in-transit totaling approximately $2.0 million as of June 30, 1990. Some of these deposits had been outstanding since August 1989. Because the OSP did not investigate and clear these large deposits-in-transit, it overdrew its bank account in the Centralized Treasury Trust System in April 1990 by approximately $507,000. It overdrew its bank account again in June 1990 by approximately $1.0 million. The OSP did not investigate the outstanding deposits-in-transit because it had not prepared bank reconciliations for approximately four months during fiscal year 1989-90 because of a vacant personnel position. As a result, it did not discover that staff was not following procedures when depositing receipts.

Criteria
The State Administration Manual, Section 8047, states that agencies must make every effort to prevent overdrafts in their centralized State Treasury System accounts. Also, the State Administration Manual, Section 8060, requires that bank reconciliations be performed promptly at the end of the month.

Recommendation
The Office of State Printing should prepare prompt bank reconciliations to prevent overdrawing its Centralized Treasury System Account and to monitor any long-outstanding deposits-in-transit.

Failure To Follow Procedures When Equipment Is Disposed

Finding

The department did not always follow state requirements when it disposed of state property. We found that the department disposed of equipment with a total original cost of approximately $120,000 before receiving approval from the property reutilization administrator. For example, without receiving proper authorization from the property reutilization administrator, the Office of Management Technology and Planning (OMTP) disposed of state property with an original cost in 1979 of approximately $86,500. Even though the value of this property was probably greatly diminished from its original cost, the OMTP could not comply with a request to send the equipment to the reutilization office for potential re-use because it had been disposed. Failure to obtain proper authorization before disposing of property may result in disposals that do not comply with management policies and may not allow the State to re-utilize its equipment.

Criteria

The State Administrative Manual, Section 8640, requires departments to receive approval from Property Reutilization before disposing of state property.

Recommendation

The department should ensure that it obtains the necessary approvals before disposing of state property.

Public Employees' Retirement System

We reviewed the Public Employees' Retirement System's (PERS) compliance with federal and state regulations for the Statewide Cost Allocation Plan (SWCAP) and state regulations for the Prorata Allocation Plan (Prorata).

Minor Errors and Omissions

Finding

The PERS made some minor clerical errors and omitted some administrative expenses in accumulating its SWCAP and Prorata costs related to health benefits for retired annuitants and in reporting those costs to the Department of Finance. Because of these errors and ommissions, the State's General Fund collected approximately $2,300 more for reimbursement of the PERS central service costs than the fund should have received. Approximately $1,500 of the $2,300 is from the State's special funds, and about $800 is from federal programs.

Criteria

The State Administrative Manual, Section 8752, requires state agencies to recover full costs for goods or services provided for other state agencies.

Recommendation

The PERS should report the corrected expenditures for health benefits for retired annuitants to the Department of Finance no later than July 31, 1990, so that the Department of Finance can include the adjustments in the fiscal year 1991-92 SWCAP and Prorata.

Youth and Adult Correctional

Department of Corrections

We reviewed the financial operations and related internal controls at the Department of Corrections (department).

Long Outstanding Salary Advances

Finding

The department has not promptly collected outstanding salary advances made to employees from its revolving fund. As of May 31, 1990, the department had a total of $130,841 in outstanding salary advances, of which $69,321 (53 percent) was more than 60 days old. In addition, department records indicate that at least 24 of the outstanding advances totaling approximately $12,000 are more than three years old. The department should first try to collect the outstanding advances from the individual. If this fails, the department can attempt to offset the individual's income tax refund, or it can clear outstanding advances by obtaining relief from accountability from the State Board of Control. Failure to follow-up promptly on outstanding advances may result in the loss of state funds if employees leave state service without repaying the advance. In addition, until the department takes appropriate action either to collect or to clear these outstanding advances, this uncollected money is not available for other uses.

Criteria

The State Administrative Manual, Section 8118, requires agencies to collect salary advances from the next payroll warrant issued for the period of the advance. In addition, the State Administrative Manual, Section 8710.1, states that if all reasonable collection procedures do not result in payment, the department may request relief from accountability for uncollectible amounts by filing an Application for Discharge from Accountability.

Recommendation

The department should follow-up on its long outstanding salary advances and pursue collection of the amounts owed or request relief from accountability for those advances that it deems uncollectible.

Deficiencies in Administering State Contracts

Finding

The department did not comply with the California Public Contract Code in establishing and maintaining contracts with vendors. Of the ten contracts that we examined for approximately $295,000 in services, eight did not comply with provisions of the Public Contract Code.

For eight of the contracts, the department did not complete the contractor evaluations within 30 days of the completion of the contract, as required. In addition, for two of the contracts and in another instance disclosed in our testing of accounts payable, we found that the contractor began contract work before either the department or the Department of General Services (DGS) approved the contract.

Without contractor evaluations, the State may contract with unreliable vendors. In addition, if the department allows contractors to begin work before the contract is approved, the state may be liable for work that is not approved.

Criteria

The Public Contract Code, Sections 10347(a) and 10369(a), requires agencies to prepare and submit a contractor evaluation to the DGS within 30 days after the completion of the contract. In addition, the Public Contract Code, Sections 10335 and 10360, states that identified contracts, unless exempt, are of no effect unless and until approved by the DGS. Further, the State Administrative Manual, Section 1209, requires agencies to submit these contracts in time for the DGS to approve the contract before work commences. Although one of the contracts under discussion in this finding was exempt from approval by the DGS, the rationale for the DGS's approving a contract before work begins supports the conclusion that the department should approve contracts before the contractor begins work.

Recommendation

The department should follow contract policies and procedures as set forth in the Public Contract Code to ensure that the contracts are properly awarded and completed in the State's best interest.

Noncompliance With State Requirements

Findings and Criteria

In the following instances, the department did not always comply with the administrative requirements of the State.

- The department did not return to the State Controller's Office 21 undelivered salary warrants, totaling approximately $4,000, that were more than 90 days old. The State Administrative Manual, Section 8580.5, requires agencies to return all undelivered salary warrants that are more than 90 days old to the State Controller's Office for deposit in the Special Deposit Fund.

- The department did not cancel five revolving fund checks, totaling $511, that were outstanding for more than two years. The State Administrative Manual, Section 8042, requires agencies to cancel revolving fund checks that are more than two years old and transfer the amount of the checks to the Special Deposit Fund.

- The department has not filed a claim with the State Board of Control to reimburse its general checking account for a cash deficiency of $514 that is more than ten years old. The State Administrative Manual, Section 8072.3, allows an agency to file a claim with the State Board of Control to replenish an established fund balance for a cash deficiency.

Although individually these instances of noncompliance may appear to be insignificant, any deviation from the State's system of internal controls make the public's resources vulnerable to abuse.

Recommendation

The department should improve its compliance with each of the state requirements.

Department of the Youth Authority

We reviewed the financial operations and internal controls of the Department of the Youth Authority (department) and the department's administration of two federal programs. These programs are the U.S. Department of Agriculture grants, Federal Catalog Numbers 10.553 and 10.555.

Overpayments to Foster Home

Finding

The department overpaid a foster home provider for services provided to a ward of the department. These overpayments occurred because the department's parole agents did not promptly notify accounting services when the ward left, or was removed from, the foster home. When the department makes an overpayment to an active foster home provider, it can deduct the amount of the overpayment from subsequent payments to the provider. However, in one case we reviewed, parole agents did not notify accounting services of the ward's departure from the foster home until seven months after the ward had left the foster home. As a result, the department overpaid this provider by more than $8,300. Furthermore, the department has been unable to locate the foster home provider and, therefore, may not recover the overpayment. In response to this incident, the deputy director of the Parole Services Branch issued a memorandum to parole agents reminding them of the policies to promptly forward stop-payment notices to accounting services.

Criteria

The department's Accounting Procedures Manual for Parole Services, Section 8194, requires parole agents to notify accounting services when a ward leaves, or is removed from, a foster home. The parole agent is required to complete a stop-payment notice and forward the notice to accounting services. In addition, the Accounting Procedures Manual, Section 8197, requires the supervising parole agent to verify a monthly listing of wards recorded as being in a foster home or group home and return the listing to accounting services before the fifth day of the following month.

Recommendation

The department should ensure that accounting services is provided with accurate and timely information to avoid overpayments to foster home providers.

Deficiencies in Administering State Contracts

Finding

The department does not always comply with all state requirements when administering contracts. We found the following specific deficiencies:

- For eight of the ten contracts we reviewed, the department did not complete the contractor evaluations within 30 days of the completion of the contract as required;

- For the one consulting contract we reviewed, the department did not request or review a contractor evaluation form from the Department of General Services prior to awarding the contract; and

- For two of ten contracts we reviewed, the contractor began work before the Department of General Services approved the contract.

Because the department does not promptly complete contractor evaluation forms, neither the department nor the Department of General Services can be sure that the contractor has satisfactorily completed the contract. In addition, without reviewing contractor evaluation forms, the department cannot be sure that it is awarding a contract to the most qualified bidder. Finally, if the department allows contractors to begin work on contracts prior to approval, the state may be liable for work that is not approved.

Criteria

During the period of our review, the Public Contract Code, Sections 10347 and 10369, required agencies to submit a contractor evaluation to the Department of General Services within 30 days after the completion of every contract. In addition, the Public Contract Code, Section 10371, stated that no contract for consultant services can be awarded until the agency has either reviewed a contractor evaluation form on file with the Department of General Services or has obtained a completed resume from each major contract participant who has not previously had a state contract. Moreover, the State Administrative Manual, Section 1209, requires agencies to submit each contract in time for the Department of General Services to approve the contract before work commences. Finally, the Public Contract Code, Section 10335, states that all contracts for services, unless exempt, are of no effect until approved by the Department of General Services.

Recommendation

The department should follow contract policies and procedures as set forth in the Public Contract Code and the State Administrative Manual to ensure that the contracts are properly awarded and completed in the State's best interest.

Noncompliance With State Requirements

Finding

We noted the following instances where the department did not comply with the administrative requirements of the State:

- For two of three invoices that we reviewed that offered vendor discounts, the department did not take advantage of discounts totaling $21. The State Administrative Manual, Section 8422.1, requires that agencies ensure that cash discounts have been taken before submitting invoices for payment.

- The department did not promptly cancel 19 trust fund checks, totaling approximately $166, that were outstanding for over four years. The State Administrative Manual, Section 8042, requires agencies to cancel trust fund checks that have been outstanding for four years and to credit the amount of such checks to the depositors or special trust accounts.

- For four of five employee separations that we reviewed, the department could not provide evidence that it reviewed the employees' records for outstanding salary or travel advances before it released the employees' final salary warrants. The

State Administrative Manual, Section 8580.4, requires agencies to ensure that all outstanding advances have been collected before the agency distributes the final salary warrant to a separating employee.

Although individually these instances of noncompliance may not appear to be significant, they are deviations from the State's system of internal controls, which are designed to ensure that the public's resources are not vulnerable to abuse.

Recommendation

The department should comply with the requirements of the State Administrative Manual.

Noncompliance With Nutritional Requirements

Finding

The department did not ensure that its facilities served sufficient quantities of foods required by the federal School Breakfast Program and the National School Lunch Program or that its facilities fully documented the contents of meals. We reported a similar weakness in our audit of the department for fiscal year 1988-89. We found the following specific deficiencies:

- The Northern California Youth Center did not provide the required servings of milk for 4 of the 48 breakfast and lunch meals that we reviewed. In addition, the facility did not maintain complete meal content records for 6 of the other meals that we reviewed. Consequently, we could not determine if the amount provided satisfied the federal serving size requirements.

- The Fred C. Nelles School did not provide the required serving sizes for fruits and vegetables for 3 of the 48 breakfast and lunch meals that we reviewed. In addition, the facility did not maintain complete meal content records for 11 of the other meals reviewed. Consequently, we could not determine if the amount provided satisfied the federal serving size requirements.

- The Preston School of Industry did not provide the required serving size for bread for one of the 48 breakfast and lunch meals that we reviewed.

As a result of these deficiencies, the department claimed reimbursement for meals that were not fully documented or did not meet the serving size requirements of the School Breakfast Program and the National School Lunch Program.

Criteria

The Code of Federal Regulations, Title 7, Sections 210.10(c) and 220.8, specifies the minimum quantities of food items to be served at meals reimbursed through the School Breakfast Program and the National School Lunch Program.

Recommendation

The department should ensure that its facilities serve at least the minimum required amounts of food items at meals reimbursed under the School Breakfast Program and the National School Lunch Program, and it should maintain appropriate supporting records.

Report on Compliance With Federal Grant Requirements

Kurt R. Sjoberg, Auditor General (acting)

State of California
Office of the Auditor General
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Independent Auditors' Report

Members of the Joint Legislative Audit Committee
State of California

We have audited the general purpose financial statements of the State of California for the year ended June 30, 1990, and have issued our report thereon dated December 14, 1990. These general purpose financial statements are the responsibility of the State's management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit.

In connection with our audit of the State's general purpose financial statements and with our study and evaluation of the State's internal control structure used to administer federal financial assistance programs as required by the Office of Management and Budget (OMB), Circular A-128, *Audits of State and Local Governments*, we selected certain transactions applicable to certain nonmajor federal financial assistance programs for the year ended June 30, 1990.

As required by OMB, Circular A-128, we have performed auditing procedures for certain nonmajor federal financial assistance programs to test compliance with the requirements governing types of services allowed or unallowed, eligibility, and any special tests and provisions that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on the State's compliance with those requirements. Accordingly, we do not express such an opinion.

In addition, we have audited the State's compliance with the specific requirements governing types of services allowed or unallowed; eligibility, matching, level of effort, or earmarking; reporting; claims for advances and reimbursements; amounts claimed or used for matching; and any special tests and provisions that are applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Assistance, for the year ended June 30, 1990. The State's management is responsible for the State's compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We have also applied procedures to test the State's compliance with the following general requirements applicable to each of its major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Assistance, for the fiscal year ended June 30, 1990: political activity, Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, and federal financial reports. Our procedures were limited to the applicable procedures described in the OMB's *Compliance Supplement for Single Audits of State and Local Governments*. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on the State's compliance with the general requirements listed above. Accordingly, we do not express such an opinion.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB, Circular A-128. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement. Further, those standards and OMB, Circular A-128, require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements and evidence about the State's compliance with those requirements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

The scope of our audit did not extend to programs administered by the University of California. The University of California contracts with independent certified public accountants for a financial and an OMB, Circular A-110, audit. Results of the OMB, Circular A-110, audit of the University of California are not included in this report. In addition, our audit of charges made by subrecipients of federal funds was limited to a review of the State's system for monitoring those subrecipients. Subrecipients, such as local educational agencies, counties, and certain cities, special districts, and nonprofit agencies, have OMB, Circular A-128, audits or OMB, Circular A-110, audits performed by independent auditors or state agencies. The scope of our audit includes evaluating the State's reviews of those audit reports prepared by independent auditors and reviewing the audit reports prepared by state agencies.

The results of our audit procedures disclosed immaterial instances of noncompliance with the specific requirements referred to above. We discuss those instances of noncompliance and present recommendations to correct them on pages 51 through 327 of our report. Management's comments regarding the recommendations appear on page 395 of this report. Additionally, beginning on page 377, we present a schedule listing instances of noncompliance that we consider to be minor. Specific responses to the instances of noncompliance identified at each state agency are on file with the Office of the Auditor General and the Department of Finance. The instances of noncompliance identified in the State's single audit report for fiscal year 1988-89 that have not been corrected are included in the section beginning on page 51. We considered all instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion the State complied, in all material respects, with the specific requirements governing types of services allowed or unallowed; eligibility; matching, level of effort, or earmarking; reporting; claims for advances and reimbursements; amounts claimed or used for matching; and any special tests and provisions that are applicable to each of its major federal financial assistance programs for the year ended June 30, 1990.

With respect to the items of nonmajor and the general requirements of the major federal financial assistance programs tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraphs. With respect to items not tested, nothing came to our attention that caused us to believe that the State had not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described on pages 51 through 327, and on page 377.

Our audit was made for the purpose of forming an opinion on the general purpose financial statements of the State taken as a whole. The Schedule of Federal Assistance on page 335 is presented for purposes of additional analysis and is not a required part of the general purpose financial statements. The OMB, Circular A-128, and the Single Audit Act of 1984 require the Schedule of Federal Assistance to present total expenditures for each federal assistance program. However, the state accounting system identifies only revenue for federal assistance programs. As a result, we present the Schedule of Federal Assistance on a revenue basis. The schedule shows the amount of federal funds and the estimated value of food stamps and commodities received by the State for the year ended June 30, 1990. The information in the schedule has been subjected to the auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, is fairly stated in all material respects in relation to the general purpose financial statements taken as a whole.

In addition to the work we performed for the OMB, Circular A-128, and the Single Audit Act of 1984 audit, we performed other reviews related to federal programs. A schedule of the pertinent reports issued from July 1, 1989, to December 31, 1990, begins on page 369 of this report.

This report is intended for the information of the California State Legislature, including the Joint Legislative Audit Committee, and the management of the executive branch. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the Joint Legislative Audit Committee, is a matter of public record.

OFFICE OF THE AUDITOR GENERAL

CURT DAVIS, CPA
Deputy Auditor General

February 15, 1991

Schedule of Federal Assistance for the Fiscal Year Ended June 30, 1990

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Department of Agriculture:		
Agricultural Conservation Program	10.063	$ 49,000
Forestry Incentives Program	10.064	13,000
Farm Labor Housing Loans and Grants	10.405	683,500
Food Distribution	10.550	92,162,428 A *
Food Stamps	10.551	907,821,516 A *
School Breakfast Program	10.553	78,500,309 A O
National School Lunch Program	10.555	381,288,994 A O
Special Milk Program for Children	10.556	952,851
Special Supplemental Food Program for Women, Infants, and Children	10.557	205,445,296 A
Child and Adult Care Food Program	10.558	85,301,354 A *

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received	
Summer Food Service Program for Children	10.559	61,827	*
State Administrative Expenses for Child Nutrition	10.560	6,803,174	
State Administrative Matching Grants for Food Stamp Program	10.561	143,615,063	A
Nutrition Education and Training Program	10.564	448,895	
Temporary Emergency Food Assistance (Administrative Costs)	10.568	3,969,197	
Cooperative Forestry Assistance	10.664	747,403	
Resource Conservation and Development	10.901	28,987	
Other--U.S. Department of Agriculture	10.999	1,120,207	
Department of Commerce:			
Trade Development	11.110	114,509	
Economic Development--Support for Planning Organizations	11.302	50,000	
Anadromous and Great Lakes Fisheries Conservation	11.405	322,613	
Interjurisdictional Fisheries Act of 1986	11.407	195,873	

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Coastal Zone Management Program Administration Grants	11.419	2,031,261
Coastal Zone Management Estuarine Research Reserves	11.420	748,646
Fisheries Development and Utilization Research and Development Grants and Cooperative Agreements Program	11.427	7,573
Other--U.S. Department of Commerce	11.999	113,022
Department of Defense:		
Flood Control Projects	12.106	15,000
Navigation Projects	12.107	60,446
Other--U.S. Department of Defense	12.999	1,102,552
Department of Housing and Urban Development:		
Mortgage Insurance--Cooperative Projects	14.126 ** (14.550)	70,006
Lower Income Housing Assistance Program--Section 8 Moderate Rehabilitation	14.156	20,725,388 A

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Supportive Housing Demonstration Program	14.235 ** (14.178)	307,397
Community Development Block Grants/Small Cities Program	14.219	257,994
Community Development Block Grants/State's Program	14.228	20,009,412 A
Emergency Shelter Grants Program	14.231	922,534
Equal Opportunity in Housing	14.400	232,490
Department of Interior:		
Small Reclamation Projects	15.503	1,353,652
Anadromous Fish Conservation	15.600	65,393
Fishery Research--Information	15.604	1,007,017
Sport Fish Restoration	15.605	7,412,361
Wildlife Restoration	15.611	3,022,830
Endangered Species Conservation	15.612	328,040
Geological Survey--Research and Data Acquisition	15.808	7,819
Historic Preservation Fund Grants-In-Aid	15.904	679,465

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Outdoor Recreation--Acquisition, Development and Planning	15.916	2,882,505
Shared Revenues--Potash/Sodium Lease	15.999	32,073,399 A
Other--U.S. Department of the Interior	15.999	2,994,510
Department of Justice:		
Juvenile Justice and Delinquency Prevention--Allocation to States	16.540	4,875,488
Juvenile Justice and Delinquency Prevention--Special Emphasis	16.541	5,731
Criminal Justice Statistics Development	16.550	86,000
Justice Research and Development Project Grants	16.560	850,000
Mariel-Cubans	16.572	275,068
Criminal Justice Discretionary Grant Program	16.574	2,626,675
Crime Victim Assistance	16.575	3,272,469
Crime Victim Compensation	16.576	13,610,000
Drug Control and System Improvement--Formula Grant	16.579	15,065,296

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Corrections--Technical Assistance/ Clearinghouse	16.603	24,601
Other--Department of Justice	16.999	979,347
Department of Labor:		
Labor Force Statistics	17.002	4,532,899
Employment Service	17.207	77,778,284 A
Unemployment Insurance	17.225	264,288,923 A
Senior Community Service Employment Program	17.235	5,425,624
Employment and Training Assistance--Dislocated Workers	17.246	32,027,424 A
Employment Services and Job Training--Pilot and Demonstration Programs	17.249	1,256
Job Training Partnership Act	17.250	274,954,654 A
Occupational Safety and Health	17.500	17,108,559
Mine Health and Safety Grants	17.600	46,227
Disabled Veterans Outreach Program	17.801	10,100,910
Veterans Employment Program	17.802	585,097

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received	
Local Veterans Employment Representative Program	17.804	6,528,658	
Department of Transportation:			
Boating Safety Financial Assistance	20.005	3,660,942	
Airport Improvement Program	20.106	41,281	
Highway Planning and Construction	20.205	1,218,642,683	A
Motor Carrier Safety	20.217	2,584,437	
Grants-In-Aid for Railroad Safety--State Participation	20.303	65,152	
Local Rail Service Assistance	20.308	26,097	
Urban Mass Transportation Capital Improvement Grants	20.500	12,689,391	O
Urban Mass Transportation Technical Studies Grants	20.505	487,845	O
Urban Mass Transportation Capital and Operating Assistance Formula Grants	20.507	161,981	O
Public Transportation for Nonurbanized Areas	20.509	3,431,988	
State and Community Highway Safety	20.600	10,545,971	

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Pipeline Safety	20.700	288,062
State Marine Schools	20.806	110,062
Other--U.S. Department of Transportation	20.999	131,664
Department of Treasury:		
Other--U.S. Department of Treasury	21.999	21,097
Equal Employment Opportunity Commission:		
Employment Discrimination--State and Local Anti-Discrimination Agency Contracts	30.002	1,671,743
General Services Administration:		
Donation of Federal Surplus Personal Property	39.003	209,184
National Aeronautics and Space Administration:		
Aerospace Education Services Project	43.001	47,420

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
National Foundation on the Arts and the Humanities:		
Promotion of the Arts--Dance	45.002	50,000
Promotion of the Arts--Arts in Education	45.003	100,000
Promotion of the Arts--State Program	45.007	655,007
Promotion of the Arts--Challenge Grants	45.013	113,624
Promotion of the Arts--Folk Arts	45.015	30,000
Promotion of the Humanities--Fellowships for College Teachers and Independent Scholars	45.143	6,874
National Science Foundation:		
Engineering Grants	47.041	119,928
Materials Development, Research, and Informal Science Education	47.067	28,401
Small Business Administration:		
Business Development Assistance to Small Business	59.005	8,800

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Department of Veterans Affairs:		
Grants to States for Construction of State Home Facilities	64.005	3,146,722
Veterans State Domiciliary Care	64.014	2,285,959
Veterans State Nursing Home Care	64.015	4,388,655
Veterans State Hospital Care	64.016	103,678
Veterans Educational Assistance	64.111	45,817
Other--U.S. Department of Veterans Affairs	64.999	1,049,749
Environmental Protection Agency:		
Air Pollution Control Program Support	66.001	4,191,245
Air Pollution Control--Technical Training	66.006	64,400
Air Pollution Control--National Ambient Air and Source Emission Data	66.007	101,212
Construction Grants for Wastewater Treatment Works	66.418	603,956
Water Pollution Control--State and Interstate Program Support	66.419	5,293,110

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
State Underground Water Source Protection	66.433	307,384
Water Pollution Control--Lake Restoration Cooperative Agreements	66.435	27,836
Construction Management Assistance	66.438	4,800,883
Water Quality Management Planning	66.454	1,586,678
National Estuary Program	66.456	519,937
Capitalization Grants for State Revolving Funds	66.458	8,121,622
Nonpoint Source Reservation	66.459	1,214,726
Nonpoint Source Implementation	66.460	574,280
Solid Waste Disposal Research	66.504	1,412,258
Safe Drinking Water Research and Demonstration	66.506	2,125,039
Toxic Substances Research	66.507	201,328
Toxic Substances Compliance Monitoring Program	66.701	55,886
Hazardous Waste Management State Program Support	66.801	5,697,857
Hazardous Substance Response Trust Fund	66.802	5,990,573

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received	
State Underground Storage Tanks Program	66.804	589,935	
Underground Storage Tank Trust Fund Program	66.805	2,358,919	
Other--U.S. Environmental Protection Agency	66.999	947,451	
Action:			
Foster Grandparent Program	72.001	1,347,695	O
Student Community Service Program	72.005	6,301	
Senior Companion Program	72.008	7,138	
Department of Energy:			
State Energy Conservation	81.041	217,909	
Weatherization Assistance for Low-Income Persons	81.042	4,130,886	
Energy Extension Service	81.050	244,269	
Energy Conservation for Institutional Buildings	81.052	370,972	
Federal Emergency Management Agency:			
Flood Insurance	83.100	237,537	

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Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Emergency Management Institute-- Field Training Program	83.403	356,075
Civil Defense--State and Local Emergency Management Assistance	83.503	5,087,783
State Disaster Preparedness Grants	83.505	17,330
Facility Survey, Engineering and Development	83.509	175,937
State and Local Emergency Operating Centers	83.512	232,470
State and Local Warning and Communication Systems	83.513	2,994
Population Protection Planning	83.514	422,784
Disaster Assistance	83.516 ** (83.300)	74,454,661 A
Hazard Mitigation Assistance	83.519	11,765
Earthquake Hazards Reduction Grants	83.521	784,912
Radiological Defense	83.522	477,160

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Department of Education:		
Adult Education--State-Administered Basic Grant Program	84.002	8,827,201
Bilingual Education	84.003	1,296,209
Desegregation Assistance, Civil Rights Training, and Advisory Services	84.004	540,866
Supplemental Educational Opportunity Grants	84.007	7,649,487
Education of Handicapped Children in State Operated or Supported Schools	84.009	1,347,344
Chapter 1 Programs--Local Educational Agencies	84.010	470,252,906 A
Migrant Education--Basic State Formula Grant Program	84.011	90,768,359 A
Educationally Deprived Children--State Administration	84.012	4,795,054
Chapter 1 Program for Neglected and Delinquent Children	84.013	2,981,537
Handicapped Education--Deaf-Blind Centers	84.025	244,219
Handicapped--State Grants	84.027	142,012,699 A

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received	
Handicapped Education--Special Education Personnel Development	84.029	98,711	
Guaranteed Student Loans	84.032	212,624,631 A	
College Work-Study Program	84.033	9,294,148	
Public Library Services	84.034	7,873,591	
Interlibrary Cooperation	84.035	2,167,213	
National Defense/National Direct/ Perkins Loans Cancellations	84.037	592,352	
Perkins Loan Program--Federal Capital Contributions	84.038	1,460,647	
Vocational Education--Basic Grants to States	84.048	73,170,339 A	
Vocational Education--Consumer and Homemaking Education	84.049	3,051,743	
Vocational Education-- State Councils	84.053	439,235	
Higher Education--Cooperative Education	84.055	11,372	
Pell Grant Program	84.063	83,902,194	B
Higher Education--Veterans Education Outreach Program	84.064	12,950	
Grants to States for State Student Incentives	84.069	11,105,902	

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Handicapped Education--Severely Handicapped Program	84.086	187,076
Indian Education--Fellowships for Indian Students	84.087	22,060
Patricia Roberts Harris Fellowships	84.094	21,963
Rehabilitation Services--Basic Support	84.126	118,092,786 A O
Rehabilitation Services--Service Projects	84.128	1,212,755
Rehabilitation Training	84.129	127,433
Centers for Independent Living	84.132	473,339
Transition Program for Refugee Children	84.146	5,352,152
Federal, State, and Local Partnerships for Educational Improvement	84.151	56,113,053 A
Public Library Construction	84.154	256,851
Removal of Architectural Barriers to the Handicapped	84.155	12,892
Emergency Immigrant Education	84.162	14,100,152
Eisenhower Mathematics and Science Education--State Grants	84.164	10,756,840

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Comprehensive Services for Independent Living	84.169	1,192,104
Jacob K. Javits Fellowships	84.170	32,000
Handicapped--Preschool Grants	84.173	26,571,229 A
Vocational Education--Community Based Organizations	84.174	542,571
Paul Douglas Teacher Scholarships	84.176	1,991,506
Handicapped Infants and Toddlers	84.181	5,100,000
Robert C. Byrd Honors Scholarships	84.185	861,746
Drug-Free Schools and Communities--State Grants	84.186	23,659,466 A
Supported Employment Services for Individuals with Severe Handicaps	84.187	5,661,942
Adult Education for the Homeless	84.192	815,439
State Activities--Education for Homeless Children and Youth	84.196	226,884
Capital Expenses	84.216	2,205,470
Compensatory Education Grant Back Awards	84.995	1,559,638

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Consumer Product Safety Commission:		
Other--Consumer Product Safety Commission	87.999	5,803
Department of Health and Human Services:		
Refugee Assistance--Mental Health	13.128	80,995
Alcohol, Drug Abuse Treatment and Rehabilitation Block Grant	13.141	10,348,851
State Comprehensive Mental Health Service Planning Development Grants	13.158	41,632
Child Support Enforcement Interstate Grants	13.785	12,185
Family Support Payments to States--Assistance Payments	93.020 ** (13.780)	2,534,925,753 A O
Job Opportunities and Basic Skills Training	93.021 ** (13.781)	79,479,198 A
Assistance Payments--Research	93.022 ** (13.782)	123
Child Support Enforcement	93.023 ** (13.783)	127,644,292 A O

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
State Legalization Impact Assistance Grants	93.025 ** (13.786)	336,093,263 A O
Refugee and Entrant Assistance--State Administered Programs	93.026 ** (13.787)	174,850,211 A
Low-Income Home Energy Assistance	93.028 ** (13.789)	45,413,172 A
Work Incentive Program/WIN Demonstration Program	93.029 ** (13.790)	979,001
Community Services Block Grant	93.031 ** (13.792)	27,446,841 A
Community Services Block Grant Discretionary Awards--Community Food and Nutrition	93.033 ** (13.795)	138,393
Emergency Community Services for the Homeless	93.034 ** (13.796)	1,729,789
Food and Drug Administration--Research	93.103 ** (13.103)	262,251
Maternal and Child Health Federal Consolidated Programs	93.110 ** (13.110)	115,967

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Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116 ** (13.116)	225,300
Acquired Immunodeficiency Syndrome (AIDS) Activity	93.118 ** (13.118)	8,200,861
Mental Health Planning and Demonstration Projects	93.125 ** (13.125)	266,978
Emergency Medical Services for Children	93.127 ** (13.127)	44,749
Injury Prevention and Control Research Projects	93.136 ** (13.136)	55,000
Drug and Alcohol Abuse Prevention--High-Risk Youth Demonstration Grants	93.144 ** (13.144)	559,525
Temporary AIDS Drug Reimbursements	93.146 ** (13.146)	2,679,559
Mental Health Services for the Homeless Block Grant	93.150 ** (13.150)	4,289,363
Community Youth Activity Demonstration Grants	93.170 ** (13.170)	3,843

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Community Youth Activity Program Block Grants	93.171 ** (13.171)	64,686
Drug Abuse Treatment Waiting List Reduction Grants	93.175 ** (13.175)	12,293,433
State Data Collection--Uniform Alcohol and Drug Abuse Data	93.179 ** (13.179)	148,923
Scholarships for the Undergraduate Education of Professional Nurses	93.182 ** (13.182)	8,238
Mental Health Research Grants	93.242 ** (13.242)	372,013
Mental Health Clinical or Service Related Training Grants	93.244 ** (13.244)	105,709
Childhood Immunization Grants	93.268 ** (13.268)	891,675
Centers for Disease Control--Investigations and Technical Assistance	93.283 ** (13.283)	355,883
Professional Nurse Traineeships	93.358 ** (13.358)	112,063

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Nursing Student Loans	93.364 ** (13.364)	108,673
Cancer Control	93.399 ** (13.399)	64,842
Administration on Developmental Disabilities--Basic Support and Advocacy Grants	93.630 ** (13.630)	4,654,400
Special Programs for the Aging--Title III, Part B--Grants for Supportive Services and Senior Centers	93.633 ** (13.633)	26,581,968 A
Special Programs for the Aging--Title III, Part C--Nutrition Services	93.635 ** (13.635)	37,500,191 A
Special Programs for the Aging--Title III, Part D--In-Home Services for Frail Older Individuals	93.641 ** (13.641)	519,072
Child Welfare Services--State Grants	93.645 ** (13.645)	25,379,381 A
Administration for Children, Youth and Families--Adoption Opportunities	93.652 ** (13.652)	296

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Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Temporary Child Care and Crisis Nurseries	93.656 ** (13.656)	188,597
Foster Care--Title IV-E	93.658 ** (13.658)	314,113,984 A O
Adoption Assistance	93.659 ** (13.659)	18,270,381
Social Services Block Grant	93.667 ** (13.667)	310,148,526 A
Special Programs for the Aging--Title IV--Training, Research and Discretionary Projects and Programs	93.668 ** (13.668)	247,472
Administration for Children, Youth and Families--Child Abuse and Neglect Discretionary Activities	93.670 ** (13.670)	62,009
Family Violence Prevention and Services	93.671 ** (13.671)	703,851
Child Abuse Challenge Grants	93.672 ** (13.672)	1,061,935
Grants to States for Planning and Development of Dependent Care Programs	93.673 ** (13.673)	1,694,354

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received	
Independent Living	93.674 ** (13.674)	8,627,886	
Medicare--Hospital Insurance	93.773 ** (13.773)	2,684,289	
Medicare--Supplementary Medical Insurance	93.774 ** (13.774)	7,200,251	
State Medicaid Fraud Control Units	93.775 ** (13.775)	6,863,803	
State Survey and Certification of Health Care Providers and Suppliers	93.777 ** (13.777)	9,562,080	O
Medical Assistance Program	93.778 ** (13.714)	3,627,658,842	A
Social Security--Disability Insurance	93.802 ** (13.802)	95,408,397	A
Arthritis, Musculoskeletal, and Skin Diseases Research	93.846 ** (13.846)	10,013	
Microbiology and Infectious Diseases Research	93.856 ** (13.856)	60,074	

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Preventive Health Services--Sexually Transmitted Diseases Control Grants	93.977 ** (13.977)	1,356,800
Health Programs for Refugees	93.987 ** (13.987)	999,713
Cooperative Agreements for State-Based Diabetes Control Programs and Evaluation of Surveillance Systems	93.988 ** (13.988)	154,160
Preventive Health and Health Services Block Grant	93.991 ** (13.991)	5,137,253
Alcohol and Drug Abuse and Mental Health Services Block Grant	93.992 ** (13.992)	121,104,608 A
Maternal and Child Health Services Block Grant	93.994 ** (13.994)	25,559,674 A
Other--Department of Health and Human Services	93.999 ** (13.999)	8,899,975

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Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Miscellaneous Grants and Contracts:		
Shared Revenue--Flood Control Lands	98.002	311,570
Shared Revenue--Forest Resources	98.003	66,992,359 A
Shared Revenue--Grazing Land	98.004	292,797
Federal Unemployment Benefits and Allowances	98.010	1,895,900
U.S. Department of Housing and Urban Development--College Housing Debt Service Government Program	98.013	1,267,074
U.S. Department of the Interior--Fire Prevention/ Suppression Agreement	98.014	1,145,607
U.S. Department of the Interior--Fire Prevention/ Suppression Agreement	98.015	58,272
U.S. Department of Agriculture and Various Other U.S. Departments--Fire Prevention/Suppression Agreements	98.016	9,218,884

Footnotes are presented on page 361

Federal Agency/Program Title	Federal Catalog Number	Grant Amounts Received
Miscellaneous Federal Receipts	98.099	39,090
Miscellaneous Federal Receipts	98.999	7,351,980
Miscellaneous Uncleared Collections	99.999	1,083,281
Total Grants Received		$13,681,659,546
Total Major Grants Audited in Compliance With OMB, Circular A-128		$13,098,655,916

Note: In addition, the State received $26,536,579 in Petroleum Violation Escrow Funds that can be used to supplement five federal energy-related conservation and assistance programs. The funds used to supplement these programs were audited to the extent required by the OMB, Circular A-128.

A - The Office of the Auditor General reviewed these major grants for fiscal year 1989-90 in compliance with the OMB, Circular A-128.

O - The Office of the Auditor General reviewed these grants in conjunction with various reports issued from July 1, 1989, to December 31, 1990. See the Schedule of Audit Reports Involving Federal Grants From July 1, 1989, to December 31, 1990, beginning on page 369 for a description of these reports.

B - Other independent auditors audited this grant. The grant amount is not included in the amount for total major grants audited on this page.

* - This amount includes cash, the value of commodities, and/or the value of food stamps.

** - The State of California recorded receipts under federal catalog numbers that were subsequently changed. The numbers in parentheses represent the former federal catalog numbers.

Weaknesses in Compliance With Federal Regulations By Grant Program

				Number of Occurrences [a]				
Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
Department of Agriculture								
10.550	Food Distribution	California State Department of Education	133			1		
10.551	Food Stamps	Department of Social Services	225	1	1		1	
10.553	School Breakfast Program	California State Department of Education	133			1	1	
		Department of the Youth Authority	323					1
10.555	National School Lunch Program	California State Department of Education	133			2	1	
		Department of the Youth Authority	323					1
10.557	Special Supplemental Food Program for Women, Infants, and Children	Department of Health Services	197			3		1
10.558	Child and Adult Care Food Program	California State Department of Education	133			2		
10.568	Temporary Emergency Food Assistance (Administrative Costs)	Department of Social Services	225					1

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Number of Occurrences[a]				
				Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
Department of Housing and Urban Development								
14.228	Community Development Block Grants/State's Program	Department of Housing and Community Development	55	2	1	1		
Department of Labor								
17.225	Unemployment Insurance	Employment Development Department	188	2				
17.250	Job Training Partnership Act	Employment Development Department	188			1		
Department of Transportation								
20.205	Highway Planning and Construction	Department of Transportation	88	1				1
Federal Emergency Management Agency								
83.516	Disaster Assistance	Office of Emergency Services	245				2	
Department of Education								
84.032	Guaranteed Student Loans	California Student Aid Commission	121	2				6

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

				Number of Occurrences [a]				
Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
84.048	Vocational Education--Basic Grants to States	California Community Colleges, Chancellor's Office	97	1	1			1
84.126	Rehabilitation Services--Basic Support	Department of Rehabilitation	218	2	1	2		2
84.151	Federal, State, and Local Partnerships for Educational Improvement	California State Department of Education	133			1	1	
84.173	Handicapped--Preschool Grants	California State Department of Education	133		1			
84.186	Drug Free Schools and Communities--State Grants	California State Department of Education	133		1	2	1	1
		Department of Alcohol and Drug Programs	181	1	1	2		
		Office of Criminal Justice Planning	161					1
Department of Health and Human Services								
93.020* (13.780)	Family Support Payments to States--Assistance Payments	Department of Social Services	225	2	1	1		

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

*The State of California administers some federal programs whose federal catalog numbers have been changed. The numbers in parentheses represent the former federal catalog numbers.

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Number of Occurrences[a]: Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
93.021* (13.781)	Job Opportunities and Basic Skills Training	Department of Social Services	225		1			
93.023* (13.783)	Child Support Enforcement	Department of Social Services	225	1	1			
93.025* (13.786)	State Legalization Impact Assistance Grants	Health and Welfare Agency	249		1			
		Department of Social Services	225	1				
		California State Department of Education	133			1		
93.026* (13.787)	Refugee and Entrant Assistance--State Administered Program	Department of Social Services	225	2	1	1		
93.028* (13.789)	Low-Income Home Energy Assistance	Department of Economic Opportunity	165				1	
93.031* (13.792)	Community Services Block Grant	Department of Economic Opportunity	165				1	1
93.118*[b] (13.118)	Acquired Immunodeficiency Syndrome (AIDS) Activity	Department of Health Services	197		1			
93.268*[b] (13.268)	Childhood Immunization Grants	Department of Health Services	197			1		

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

[b]We noted these weaknesses in compliance with federal regulations during audit testing at the state agency. We did not review for compliance with all federal regulations because the grant was under $20 million.

*The State of California administers some federal programs whose federal catalog numbers have been changed. The numbers in parentheses represent the former federal catalog numbers.

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Number of Occurrences [a] Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
93.633* (13.633)	Special Programs for the Aging--Title III, Part B--Grants for Supportive Services and Senior Centers	Department of Aging	179			1		
93.635* (13.635)	Special Programs for the Aging--Title III, Part C--Nutrition Services	Department of Aging	179			1		
93.645* (13.645)	Child Welfare Services--State Grants	Department of Social Services	225	2				
93.658* (13.658)	Foster Care--Title IV-E	Department of Social Services	225	3	1			
93.667* (13.667)	Social Services Block Grant	Department of Social Services	225		1	1		
93.778* (13.714)	Medical Assistance Program	Department of Health Services	197	1		1		
93.802* (13.802)	Social Security--Disability Insurance	Department of Social Services	225		2			
93.991*[b] (13.991)	Preventive Health and Health Services Block Grant	Department of Health Services	197			1		

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

[b]We noted these weaknesses in compliance with federal regulations during audit testing at the state agency. We did not review for compliance with all federal regulations because the grant was under $20 million.

*The State of California administers some federal programs whose federal catalog numbers have been changed. The numbers in parentheses represent the former federal catalog numbers.

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Number of Occurrences[a]				
				Inadequate/ Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/ Auditing	Early Request/Late Disbursement of Federal Funds	Other
93.992* (13.992)	Alcohol and Drug Abuse and Mental Health Services Block Grant	Department of Alcohol and Drug Programs	181			2		
		Department of Mental Health	212			2		
93.994* (13.994)	Maternal and Child Health Services Block Grant	Department of Health Services	197			1		
Various Federal Departments								
	Numerous Federal Programs	Office of Administrative Law	153					1
	Numerous Federal Programs	Stephen P. Teale Data Center	75					1
	Numerous Federal Programs	Department of General Services	290					1
	Numerous Federal Programs	Health and Welfare Agency Data Center	194					1
	Numerous Federal Programs	State Board of Control	159					1

[a]This is the number of occurrences of each weakness as presented in the state agencies' management letters.

*The State of California administers some federal programs whose federal catalog numbers have been changed. The numbers in parentheses represent the former federal catalog numbers.

Schedule of Audit Reports Involving Federal Grants From July 1, 1989 to December 31, 1990

From July 1, 1989, to December 31, 1990, the Office of the Auditor General issued reports on audits involving federal grants. The following schedule lists the reports issued and presents a summary of the report findings. The agencies' responses to these findings are included in each of the separate audit reports.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
Alameda-Contra Costa Transit District	Urban Mass Transportation Capital Improvement Grants, Urban Mass Transportation Technical Studies Grant, and Urban Mass Transportation Capital and Operating Assistance Formula Grants 20.500 20.505 20.507	Alameda-Contra Costa Transit District: Third through Seventh Quarterly Monitoring Reports (P-861.3, 7-7-89; P-861.4, 10-4-89; P-861.5, 12-20-89; P-861.6, 4-4-90; and P-861.7, 7-5-90) (1) Since the release of our March 1988 report about the Alameda-Contra Costa Transit District's (district) financial and administrative controls, our quarterly reports have shown that the district has improved its budgeting process. However, the district's revised budget for fiscal year 1989-90 has a projected \$2.0 million deficit primarily because of expenses the district incurred as a result of the October 1989 earthquake. (2) The district's operating budget for fiscal year 1990-91 projects that district revenues and subsidies will equal expenses, resulting in a balanced budget. The district's budget for fiscal year 1990-91 contains provisions for a fare increase to enhance district revenues and also contains funding for the implementation of the district's comprehensive service plan, which is intended to increase the number of passengers using district buses. However, the district plans to reduce some bus services to decrease its operating expenses. (3) The district has revised its rules and added new policies that appear to better control the travel and personal expenses of its directors and district officers, and it has recovered overpayments from all of its directors.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		(4) The district has added and disseminated new policies that prohibit employees from using district resources for nondistrict purposes, and it has prohibited its attorneys from engaging in private law practices while employed by the district.
Education, California State Department of	Various Department of Education and Veterans Administration programs	A Review of the State Department of Education's Authorization of Private Postsecondary Educational Institutions (P-869, 11-27-89)
		(1) The Private Postsecondary Education Division (division) of the State Department of Education does not consistently maintain sufficient documentation to allow us to determine whether it complies with current law for reviewing institutions.
		(2) For those occasions when we found sufficient documentation to test the division's compliance with review requirements, we found that the division does not always comply with the required time frames for reviewing institutions.
		(3) The division uses its own guidelines, which have not been adopted as regulations, to review institutions seeking approval or authorization to operate in the State.
Health and Welfare Agency Aging, Department of Health Services, Department of Social Services, Department of	Foster Grandparent Program 72.001 Various programs of the Department of Health and Human Services	The Departments We Reviewed Within the Health and Welfare Agency Are Not Complying With the Direct Service Contract Reforms (F-859, 7-6-89)
		(1) During our review of direct service contracts with nonprofit organizations for fiscal year 1985-86 through fiscal year 1987-88 at three departments within the Health and Welfare Agency, we found that the departments have done little to comply with the direct service contract reforms.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
Health and Welfare Agency Education, California State Department of Health Services, Department of Housing and Community Development, Department of Mental Health, Department of Social Services, Department of	State Legalization Impact Assistance Grants 93.025 (formerly 13.786)	A Review of the State's Administration of the State Legalization Impact Assistance Grants (F-944, 5-31-90) (1) During our review of the programs in the departments that administer the State Legalization Impact Assistance Grants (SLIAG) for the State, we found that most programs had adequate procedures for reviewing and processing claims to ensure that costs claimed were reasonable and allowable; for receiving and reviewing audit reports for local government subrecipients of grant monies; for auditing and monitoring subrecipients of grant monies; for identifying and recovering overpayments; and for collecting and reporting information for the primarily descriptive reports required for the SLIAG. However, several programs did have weaknesses in their procedures for reviewing and processing claims.
Health Services, Department of	State Survey and Certification of Health Care Providers and Suppliers 93.777 (formerly 13.777)	The Laboratory Field Services Within the Department of Health Services Is Not Meeting All of Its Responsibilities To Regulate Clinical and Physicians' Laboratories (P-821, 12-6-89) (1) In calendar year 1988, the Laboratory Field Services, which is within the Division of Laboratories in the Department of Health Services (department), evaluated proficiency test results for only 360 (about 22 percent) of the 1,625 laboratories that are required to participate in proficiency testing. (2) The Laboratory Field Services does not have a procedure to determine whether all of the 1,928 laboratories operated by physicians for their own patients (physicians' laboratories) are participating in proficiency testing as required; and it has not evaluated any of the proficiency test results received from physicians' laboratories. (3) The Laboratory Field Services has not always required laboratories that have failed proficiency tests for three quarters to stop providing the applicable diagnostic tests to the public.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		(4) The department has not correctly calculated annual license fees for clinical laboratories and clinical laboratory personnel and, as a result, we estimate that the department undercharged these licensees at least $1.3 million from calendar year 1985 through calendar year 1988.
		(5) The department has not promptly endorsed and deposited checks, money orders, and warrants submitted as license fees by clinical laboratories and clinical laboratory personnel.
Los Angeles County Department of Children's Services Social Services, Department of	Foster Care--Title IV-E 93.658 (formerly 13.658)	Los Angeles County Needs To Improve Its Services to Foster Children and the State Needs To Improve Its Oversight of the County's Foster Care Program (P-927, 12-12-90)
		(1) The Los Angeles County Department of Children's Services (county) is not complying with visitation and medical history requirements, and it may be placing more foster children in foster homes than the law allows.
		(2) The Department of Social Services (department) did not conduct compliance audits of the county's foster care program every three years as required and did not ensure that the county corrected deficiencies found during the last compliance audit.
		(3) The department takes an average of 12 months to process requests for license revocations against foster parents who may be neglecting or abusing children in the county.
		(4) The department failed to take the necessary steps to claim an estimated $156 million in federal funds from March 1987 to June 1, 1990, for administering the State's foster care program in all 58 counties.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
Los Angeles County Department of Mental Health	Various programs of the Department of Health and Human Services	A Review of the Los Angeles County Department of Mental Health (P-929, 12-18-89) (1) We conducted a limited scope review of the Los Angeles County Department of Mental Health (department) to assist the Legislature in determining whether a full scope audit of the department should be approved. We recommend that the Legislature authorize our office to audit the contracting functions of the department because no noncounty organization has reviewed the department's program or fiscal monitoring operations since March 1988; the department's budget for fiscal year 1989-90, according to the department's director, reflects a trend toward reducing staff and increasing contracting for mental health services; and prior audit reports included recommendations for improving the department's monitoring of programs or contractors.
Military Department	U.S. Department of Defense--Operating Reserve, Guard, and Training Facilities 98.008	A Review of Personnel Practices at the Military Department: Some Practices for State Active Duty Employees Need Improvement (P-822.1, 4-5-90) (1) At least 30 of the Military Department's (department) 210 State Active Duty (SAD) positions do not clearly require military knowledge and experience and could be converted to state civil service positions. This would save the department approximately $57,000 annually. (2) The department has not always requested and obtained approval from the Department of Finance before reclassifying SAD positions. (3) The department did not follow its regulations for announcing vacancies in 34 of 54 SAD officer positions, including 18 positions it considers "key staff."

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		(4) In a sample of 22 SAD employees who participated in federal active duty, 8 employees did not take appropriate leave from their regular duties and were inappropriately paid approximately $10,600. (5) The adjutant general, who directs the department, has the authority to place officers of the California National Guard on retired or reserve status.
Public Bus Operators	Urban Mass Transportation Capital and Operating Assistance Formula Grants 20.507	A Review of the Public Bus Operations in California (P-777.1, 9-14-89) (1) Although total operating costs for bus service provided by transit operators statewide increased slightly more than operating revenues and subsidies from fiscal year 1984-85 through fiscal year 1987-88, no notable decline occurred in the fiscal operations of operators. (2) The trends in the performance of public bus operators from fiscal year 1984-85 through fiscal year 1987-88 show that the number of passengers for public bus operators decreased while service, as measured by vehicle revenue, slightly increased. During the same period, operating costs increased. (3) From fiscal year 1984-85 through fiscal year 1987-88, vehicle maintenance costs increased for seven of eight public bus operators while most of the operators' vehicle maintenance programs appeared to be improving. (4) In our review of the competitive procurement practices of four transit operators, we determined that three transit operators did not always provide for competitive procurement of materials, supplies, and services.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		(5) In reviewing the Urban Mass Transportation Administration's most recent evaluations of four of the eight operators, we found that the operators complied with private sector participation requirements even though the operators contracted with private contractors for very little of the total cost of providing transit service.
		(6) In our review of the hiring and training practices of four public transit operators and one private contractor with which one of these public operators contracted, we noted practices common to all four operators and the contractor.
Rehabilitation, Department of	Rehabilitation Services--Basic Support 84.126	The Department of Rehabilitation Has Weaknesses in the Control and Management of Equipment Used for the Business Enterprise Program (F-958, 7-5-90)
		(1) Our audit of the Business Enterprise Program for the Blind (program), administered by the Department of Rehabilitation (department), disclosed that the department has weaknesses in its purchase and use of equipment for the program.
		(2) In some instances, the department's controls over the transfer and disposal of equipment are inadequate.
Social Services, Department of	Child Support Enforcement 93.023 (formerly 13.783)	Child Support Enforcement: Counties Are Not Properly Calculating or Restricting Their Excess Revenue (P-820, 4-12-90)
		(1) During our review of how four counties account for the incentive payments they received that exceeded their cost of administering the Child Support Enforcement Program, commonly referred to as "excess revenue," we noted that one county was not calculating its excess revenue as required by the State's "Accounting Standards and Procedures for Counties" and three counties are not restricting the use of their excess revenue to financing only future child support enforcement activities, as required by law.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		(2) The Department of Social Services (department) has neither reviewed the counties' calculations of excess revenue nor determined whether counties have established accounts to restrict their use of excess revenue. (3) The State's instructions to the counties for calculating excess revenue need revision.
Social Services, Department of	Family Support Payments to States--Assistance Payments 93.020 (formerly 13.780)	Improvements Are Needed in the State's Program To Provide Assistance to Homeless Families (P-872, 4-30-90) (1) Although the homeless assistance program meets a need to provide housing for homeless families, and since the inception of the program, counties have improved program controls, the Department of Social Services (department) and the county welfare departments have not always taken sufficient measures to limit fraud and abuse by families in the program. Additionally, the state law establishing the program and the department's regulations limit the steps that the counties can take to prevent fraud and abuse and provide for limited accountability from families who receive assistance.
Sweetwater Union High School District	School Breakfast Program 10.553 National School Lunch Program 10.555	To Adequately Manage and Protect Its Assets, the Sweetwater Union High School District Needs To Improve Its Control Over Its Financial Operations (F-962, 7-25-90) (1) Because of weak internal controls, the Sweetwater Union High School District (district) has been susceptible to misappropriation of district assets, as well as other abuses, although we found no evidence during our review to support allegations of criminal activities at the district.

Schedule of Minor Federal Issues for the Fiscal Year Ended June 30, 1990

Agency Receiving Federal Funds	Federal Grant and Federal Catalog	Description of Issue
Aging, Department of	Special Programs for the Aging--Title III, Part B and Title III, Part C--Grants for Supportive Services and Senior Citizens, and Nutrition Services, Food Distribution 93.633 (formerly 13.633) 93.635 (formerly 13.635) 10.550	(1) For 3 of the 55 claims we tested, the department held the related federal grant money for 3, 6, and 121 working days. However, the average number of working days between receipt and disbursement of funds for the claims tested was only 2.3 working days.
California Community Colleges, Chancellor's Office	State Legalization Impact Assistance Grants 93.025 (formerly 13.786)	(1) The Chancellor's Office overcharged the grant approximately $1,200 for the payroll costs of an employee who did not perform grant work. The Chancellor's Office subsequently corrected the error.
California Student Aid Commission	Guaranteed Student Loans 84.032	(1) The commission did not correctly calculate the federal share of collections on defaulted student loans for one of the 20 collections that we reviewed. The commission calculated the federal share to be approximately $10 less than the amount to which the federal government was entitled. Further, we could not determine whether the commission correctly calculated the federal share of collections for an additional four items because the commission could not locate certain records. (2) The commission did not ensure that a lender met federal requirements for disbursing a loan. For one of ten loans tested, a lender did not disburse a loan to a student borrower with more than six months remaining in the student's enrollment period in two or more payments. However, if the lender had disbursed the loan one day later, a single disbursement would have been allowed under federal regulations.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog	Description of Issue
		(3) We could not determine if two assets, valued at approximately $850, were improperly converted for use in a non-Guaranteed Student Loan Program area because we could not determine if state or federal funds were used to purchase the asset.
		(4) The commission underpaid one lender by one day's interest earned for seven defaulted student loans during the period because the lender misinterpreted the commission's claim form. We did not observe this type of error after January 1990 when the claim form was changed.
		(5) Because of a data-entry error, the commission overstated the current principal for one student loan by $1,375. Although the loan was guaranteed for an amount within the allowable limits for loans in an academic period, the student could be denied a subsequent loan if the student's recorded combined loan total exceeds allowable limits in the future.
Education, California State Department of	Chapter 1 Programs--Local Educational Agencies 84.010	(1) The department has not yet reduced the entitlements of seven local educational agencies (LEA) that failed to maintain the required fiscal effort in fiscal year 1988-89. As a result, the seven LEAs received approximately $4,700 more than they should have in fiscal year 1989-90. As of March 6, 1991, no adjustment has been made. However, the March entitlement payment has been calculated to reflect the $4,700 penalty, but it has not been made yet.
Education, California State Department of	Vocational Education--Basic Grants to States 84.048	(1) The State did not meet the required spending level from state sources for fiscal year 1987-88. Specifically, the State spent five cents less per pupil in fiscal year 1987-88 than it spent in fiscal year 1986-87. In addition, the State may not meet the required spending level for fiscal year 1988-89.
Emergency Services, Office of	Disaster Assistance 83.516	(1) The office made a clerical error when preparing a final financial report and, as a result, overstated by $9,446 the total reported expenditures of approximately $156 million. Also, the office submitted the report to the federal government two days late.
		(2) The office has not provided to each employee a copy of the policy statement as required by the Drug-Free Workplace Act.

Agency Receiving Federal Funds	Federal Grant and Federal Catalog	Description of Issue
Health Services, Department of	State Legalization Impact Assistance Grants 93.025 (formerly 13.786)	(1) The department incorrectly processed two invoices from subrecipients of the Adolescent Family Life program that were charged to the grant. The errors resulted in an overpayment of approximately $2,300 from grant monies. The department subsequently returned the overpayment.
Mental Health, Department of	State Legalization Impact Assistance Grants 93.025 (formerly 13.786)	(1) The department incorrectly charged the grant up to $19,000 for payroll and miscellaneous costs of an employee who did not perform grant work. The department did not charge the grant for the payroll costs of an employee who did perform grant work. The department subsequently corrected the errors.
Rehabilitation, Department of	Rehabilitation Services--Basic Support 84.126	(1) The department failed to properly review independent audit reports of subrecipients submitted in fiscal year 1989-90. The department accepted four of the six audit reports reviewed even though the reports were not prepared according to requirements of the United States Comptroller General. The audit reports did not include a statement of positive assurance on items of compliance that were tested or a statement of negative assurance on items of compliance that were not tested. (2) The department failed to prepare a state rehabilitation facilities plan for fiscal year 1989-90. (3) For one of the 27 client cases we reviewed, the department did not review the Individualized Written Rehabilitation Program annually.
Youth Authority, Department of the	School Breakfast Program and National School Lunch Program 10.553 10.555	(1) The department made two clerical errors that resulted in charging the federal government incorrectly for 79 meals of the 142,845 meals we tested. However, the department also made eight clerical errors that resulted in not charging the federal government for 185 meals for which it was entitled for reimbursement. As a result of these inaccurate meal counts, the department undercharged the federal government by $131.55.

STATE OF CALIFORNIA PETE WILSON, *Governor*

DEPARTMENT OF FINANCE
915 L STREET
SACRAMENTO, CA 95814-4998

March 18, 1991

Kurt R. Sjoberg
Acting Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

REPORT F-005--A REVIEW OF THE STATE'S CONTROLS OVER ITS FINANCIAL OPERATIONS

I appreciate the opportunity to respond to the draft copy of the subject report which was prepared in conjunction with your examination of the State's general purpose financial statements for the Fiscal Year ended June 30, 1990. This draft contains your findings resulting from your study and evaluation of internal controls and your report on the State's compliance with Federal grant requirements. These findings will be incorporated into the Single Audit report filed by the State of California covering Fiscal Year 1989-90.

We agree that the control of the State's financial operations is important and we are continuing to strive for improvements. As noted in your summary, the State has corrected many of the previously reported internal control weaknesses. We appreciate the concerns expressed in the identification of actual potential losses and are weighing the costs associated in recovering losses and designing control systems to reduce the potential for loss.

The State of California is a very large and diverse entity with numerous programs and activities being carried out for its citizens. It will continue to be the responsibility of all of us to work toward assuring that the assets under its control are properly guarded and the operations of its various units are carried out in the most cost efficient manner. While we know much remains to be done to effect improvements, the fact that the cumulative findings do not adversely affect the State's general purpose statements is evidence that the operation is generally working.

Each department where you have identified internal control weaknesses is responsible for responding as to what corrective actions they will take. However, the following is our response to each of the statewide concerns that you've identified in your draft.

- INCONSISTENT FINANCIAL REPORTING

We are continuing to address the issue of Generally Accepted Accounting Principles (GAAP) in several areas, including budget preparation and state agency reporting. For example, the Governor's Budget for 1989-90 Fiscal Year was changed to reflect GAAP treatment of encumbrances and continuing appropriations. Further, the Governor's Budget for the 1990-91 included a proposal to change the method of reporting outstanding purchase orders and contracts to more closely conform to GAAP. Finally, as noted in your report, the State is changing its accounting for MediCal expenditures and uncollected taxes in the 1991-92 Fiscal Year to acceptable GAAP Standards. However, because of the complexity of the State's budgeting and reporting system we are progressing cautiously before making any other changes that may be desirable.

- PROBLEMS WITH THE STATE'S CONVERSION TO GAAP

The State of California is in the process of converting to GAAP where it is in the best interest of the State. However, there are some areas of GAAP where the proper accounting treatment is impractical and costly. For example, accounting for vacation accruals requires the establishment of very expensive record systems which do not aid in the effective administration of the State. Consequently, we are proceeding cautiously.

Currently, state agencies are required to report in accordance with legal requirements. The State Controller converts this data to GAAP to issue the year-end financial statements. We are not aware of difficulties encountered by the State Controller in meeting this conversion.

- SOME INTERNAL SERVICE FUNDS DO NOT ALWAYS COMPLY WITH FEDERAL REGULATIONS

We are concerned that the State comply with all federal regulations. The administrative processes that the State's Internal Service Funds use are intended to meet the State's needs and comply with State laws and regulations. In some cases, such laws and regulations differ from those of the federal government. The State is working with the federal government to minimize those difference. Guidelines will be developed as soon as such differences are resolved.

- REVENUE COLLECTION AGENCIES ARE UNABLE TO MAKE REFUNDS AND REVENUE DISTRIBUTIONS WHEN THE STATE HAS NO BUDGET

We agree that refunds and revenue distributions should be made as soon as possible. However, as you point out in your report, the State

Controller's Office may not make refunds or revenue distributions unless the budget act is approved. The processing and approval of the budget act is a legislative responsibility and one which we do not control.

- <u>INADEQUATE ACCOUNTABILITY OVER PAYMENTS OF STATE FUNDS BY FISCAL AGENTS</u>

The Department of Finance has developed guidelines regarding fiscal agents. The guidelines require Department of Finance approval to deposit moneys not under the control of the State Treasurer in banks or savings and loans institutions outside the State Treasury System. These guidelines have been submitted to the Department of General Services to be included in the next revision of the State Administrative Manual.

- <u>DELAYS IN PRODUCING AUDITED FINANCIAL STATEMENTS</u>

The State is endeavoring to reduce the time required to prepare and submit the year-end statements to the State Controller's Office for incorporation into the annual report. Virtually all State agencies now submit statements no later than the first of September. A review of the financial statements needed for submission is now underway in several agencies. Last year's pilot project to prepare an automated report to replace a number of standard reports was generally successful and is the basis for a statewide automation project.

- <u>LACK OF COMBINING STATEMENTS BY FUND TYPE</u>

The State Controller's Office has taken the lead role in the process of determining the steps necessary to prepare a comprehensive annual report in accordance with GAAP. The State Controller is currently issuing both an annual report in accord with the State's legal basis of accounting and an annual report containing general purpose financial statements in accordance with Chapter 1286, Statutes of 1984 (AB 3372). This represents a forward step in the overall conversion to comprehensive GAAP financial statements. A proposal was submitted to your office regarding fund classification, and which should further help allow the completion of combining statements by fund type.

- <u>INSUFFICIENT ACCOUNTABILITY FOR FIXED ASSETS</u>

The State's Fixed Asset Task Force estimates that by October 1991 there should be a completion of the state-wide inventory of major fixed assets as of June 1991. Further, the Statement of General Fixed Assets, requires agencies to report acquisitions and dispositions of general fixed assets.

- NOT ALL FEDERAL RECEIPTS ARE DEPOSITED TO THE FEDERAL TRUST FUND

We recognize the need to account for funds properly, and that federal funds should be deposited to the Federal Trust Fund. In some instances, such as the two that you reported, agencies may have been unaware or misinterpreted the requirements of Government Code Section 16360. We will issue a management memo to all state agencies reminding them about this requirement.

- INELIGIBILITY FOR CERTIFICATE OF ACHIEVEMENT

As we have previously stated, we and the State Controller's Office recognize the desirability of qualifying California for the Certificate of Achievement for Excellence in Financial Reporting. Consequently, there have been established a number of committees to work toward overcoming the three major areas of concern which presently preclude us from qualifying for this award. Our responses to these areas are contained in various sections of this letter.

- INSUFFICIENT REPORTING OF LEASING INFORMATION

The development of a central record of all lease commitments by the State is an enormously difficult task. The Department of General Services is now the central depository for the bulk of the leasing information but, at this time, does not have access to all lease data. In addition, the records which are centralized do not provide all the information required by GAAP. We will continue to examine what must be done to accomplish this task and develop a plan which would eventually overcome this deficiency.

- INADEQUATE CONTROL OVER SOME CONTRACTS

As you indicate in your report, there is some legal basis for not requiring the Department of General Services to process all contracts. However, we will consider what changes are beneficial to prevent occurrences of inappropriate contracts.

- FAILURE TO REQUIRE ACCOUNTING FOR EXPENDITURES OF FEDERAL MONEYS BY EACH FEDERAL PROGRAM

We agree that the accounting system presently used to record federal moneys needs to be changed to one that will meet all federal and State requirements, and will be addressing it as other priorities allow.

Mr. Kurt R. Sjoberg
March 18, 1991
Page Five

- IMPROPER OMISSIONS FROM THE STATE REPORTING PROCESS

  The State Controller's Office is reviewing this issue to determine the feasibility of including the District Agriculture Fairs into the State reporting entity.

- FAILURE TO REQUIRE AGENCIES TO SUBMIT RECONCILIATIONS TO THE STATE CONTROLLER'S OFFICE AND FAILURE TO REQUIRE AGENCIES TO PREPARE A REPORT OF ACCRUALS

  The Department of Finance is reviewing the proposed requirements for State agencies to complete a full set of year-end reports for non Government Code Funds (including the Report of Accruals and the Reconciliation of Agency Accounts with transaction per State Controller). State agencies have been surveyed to identify the associated workload, procedures, and other complications. We will be addressing this issue as other priorities permit.

We are aware that in many areas efforts are already underway to correct and strengthen weaknesses disclosed by both your audit effort and those of our own internal control reviews. We wish to continue to show progress in our efforts to improve the controls over the State's financial operations at the statewide levels as well as at individual departments. It will take the combined efforts of all of us to achieve this goal.

Sincerely,

Thomas W. Hayes

THOMAS W. HAYES
Director of Finance

cc: Curt I. Davis, CPA
Deputy Auditor General

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Report on Compliance With State Laws and Regulations

Kurt R. Sjoberg, Auditor General (acting)

State of California
Office of the Auditor General
660 J Street, Suite 300, Sacramento, CA 95814
Telephone : (916) 445-0255

Independent Auditors' Report

Members of the Joint Legislative Audit Committee
State of California

We have audited the general purpose financial statements of the State of California as of and for the year ended June 30, 1990, and have issued our report thereon dated December 14, 1990. We did not audit the financial statements of the pension trust funds, which reflect total assets constituting 78 percent of the fiduciary funds. We also did not audit the financial statements of certain enterprise funds, which reflect 92 percent of the total assets and 96 percent of the total revenues of the enterprise funds. In addition, we did not audit the University of California funds. We did not audit the financial statements of these pension trust funds, enterprise funds, and University of California funds because they were audited by other independent auditors.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the comptroller general of the United States. Those standards required that we plan and perform our audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement.

The management of state agencies is responsible for compliance with laws, regulations, contracts, and grants applicable to the State of California. As part of obtaining reasonable assurance about whether the general purpose financial statements are free of material misstatement, we performed tests of the State of California's compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests of compliance indicate that, for the items tested, the State of California complied, in all material respects, with the provisions referred to in the preceding paragraph of this report. We noted certain immaterial instances of noncompliance that we have reported to the management of agencies of the State of California. We discuss these on pages 51 through 327 of this report. For items not tested, nothing came to our attention that caused us to believe that the State of California had not complied, in all material respects, with those provisions.

This report is intended for the information of the California State Legislature, including the Joint Legislative Audit Committee, and the management of the executive branch. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the Joint Legislative Audit Committee, is a matter of public record.

OFFICE OF THE AUDITOR GENERAL

CURT DAVIS, CPA
Deputy Auditor General

February 15, 1991

Appendix A Schedule of Actual and Potential Losses Identified During Our Review of the State's Financial Activities

	Page Number	Lost Interest and Discounts	Amounts Owed to the State for Extended Periods	Unnecessary Expenditures	Lost Revenue
Alcohol and Drug Programs, Department of	181	$ 56,000			
Chiropractic Examiners, Board of	155	1,912	$ 1,000		
California Community Colleges, Chancellor's Office	97	40,700	15,243		
California State University	115	58,000	61,579	$ 352	
Corrections, Department of	319		69,321		
Criminal Justice Planning, Office of	161	127,000			
Economic Opportunity, Department of	165		896,784		
Education, California State Department of	133				$ 66,400
Franchise Tax Board	263	574,000	885,707	1,592,700	47,600
General Services, Department of	290		8,500,000		
Health Services, Department of	197	645,500	41,000	10,000	
Housing and Community Development, Department of	55		1,100,000		
Mental Health, Department of	212		34,102		
Motor Vehicles, Department of	65		10,200,000	200,000	60,000
Social Services, Department of	225	1,281,700		7,700	
Transportation, Department of	88				41,600
Youth Authority, Department of the	323	21		8,300	
Total		$2,784,833	$21,804,736	$1,819,052	$215,600

Appendix B Reports Issued by the Office of the Auditor General From July 1, 1989 to December 31, 1990

Date of Issue	Report Title	Report No.
1989		
Jul 06	The Departments We Reviewed Within the Health and Welfare Agency Are Not Complying With the Direct Service Contract Reforms	F-859
Jul 07	Alameda-Contra Costa Transit District: Third Quarterly Monitoring Report	P-861.3
Aug 09	The Department of Motor Vehicles Can Improve Its Administration of the International Registration Plan	F-833
Aug 14	A Review of the Riverside County Department of Mental Health's Contracts With the Harvest of Wellness Foundation (Letter Report)	P-874
Aug 21	An Estimate of Oakland Unified School District's Current and Future Financial Condition (Letter Report)	F-931
Aug 28	A Review of the Operations and Funding of the California Relay Service (Letter Report)	P-827
Aug 31	California's Hazardous Waste Management Program Continues To Improve but Needs To More Fully Enforce State Laws and Regulations	P-831

Date of Issue	Report Title	Report No.
Sep 07	State of California, Statements of Securities Accountability of the State Treasurer's Office, June 30, 1988	F-803
Sep 12	A Review of the Independent Audits Performed on the San Diego Unified Port District (Letter Report)	F-916
Sep 13	Public Reports of Investigations Completed by the Office of the Auditor General From July 1, 1988 Through July 31, 1989	I-943
Sep 14	A Review of Public Bus Operations in California	P-777.1 Vol.1 & 2
Oct 04	Alameda-Contra Costa Transit District: Fourth Quarterly Monitoring Report	P-861.4
Nov 27	A Review of the State Department of Education's Authorization of Private Postsecondary Educational Institutions (Letter Report)	P-869
Dec 06	The Laboratory Field Services Within the Department of Health Services Is Not Meeting All of Its Responsibilities To Regulate Clinical and Physicians' Laboratories	P-821
Dec 18	A Review of the Los Angeles County Department of Mental Health (Letter Report)	P-929
Dec 20	Alameda-Contra Costa Transit District: Fifth Quarterly Monitoring Report	P-861.5

Date of Issue	Report Title	Report No.
1990		
Jan 04	The Administration of the State's Domestic Violence Diversion Program Could Be Improved	P-852
Jan 22	A Review of the Vehicle Maintenance Programs and the Availability of Two-Way Radios at Two State Correctional Institutions (Letter Report)	P-918
Jan 24	Because of Poor Management Controls, the Oakland Unified School District Is Not Adequately Protecting Its Assets	F-931.1
Jan 24	A Review of the Oakland Unified School District's Financial Position	F-931.2
Jan 31	Audit of the California Network System (CALNET) Acquisition	P-949.1
Feb 05	The Department of Motor Vehicles Did Not Comply With All the State Procurement Requirements (Letter Report)	P-949.2
Feb 12	California Exposition and State Fair's Financial Status for the Fiscal Year Ending June 30, 1989 (Letter Report)	F-922
Feb 12	A Review of the California Authority of Racing Fairs' Procurement of Goods and Services for Simulcasting (Letter Report)	P-938
Feb 21	State of California, Financial Report, Year Ended June 30, 1989	F-900

Date of Issue	Report Title	Report No.
Mar 07	The Department of General Services Needs To Improve Its Management of State Leases and Real Estate	P-839.1
Mar 14	A Review of the Office of Statewide Health Planning and Development's Procedures for Ensuring That Health Facilities Meet Seismic Safety Standards	P-876
Mar 28	A Financial Review of the City of Imperial Beach	C-959
Mar 28	A Review of the State's Controls Over Its Financial Operations	F-904
Mar 30	State of California Comprehensive Financial and Compliance Audit Report, Year Ended June 30, 1989	F-905
Apr 04	The Alameda-Contra Costa Transit District: Sixth Quarterly Monitoring Report	P-861.6
Apr 05	A Review of the Personnel Practices at the Military Department: Some Practices for State Active Duty Employees Need Improvement	P-822.1
Apr 06	A Review of the Department of Food and Agriculture's Management of Its Milk Marketing Program (Letter Report)	P-843
Apr 12	Child Support Enforcement: Counties Are Not Properly Calculating or Restricting Their Excess Revenue	P-820

Date of Issue	Report Title	Report No.
Apr 25	The California Museum of Science and Industry Needs To Modify Its Agreement With Its Foundation and Improve Management Controls	P-939
Apr 30	Improvements Are Needed in the State's Program To Provide Assistance to Homeless Families	P-872
May 03	A Comparison of the State Board of Equalization's Appraisals of the Cellular Telephone Industry's Taxable Property With the Appraisals of Similar Industries' Taxable Property	P-936
May 16	The State Department of Education's Juvenile Court and Community Schools (Letter Report)	C-941
May 31	A Review of the State's Administration of the State Legalization Impact Assistance Grants	F-944
Jun 01	State of California, Statement of Securities Accountability of the State Treasurer's Office, June 30, 1989	F-903
Jun 20	A Review of the Los Angeles Community College District's Management of Construction Projects (Letter Report)	C-948
Jun 27	A Review of the Purchasing Practices and Conflict of Interest Policies in the Selection of School Textbooks	P-935
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