



Joint Legislative Audit Committee  
Office of the Auditor General



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**FINANCIAL AUDIT REPORT  
STATE BANKING DEPARTMENT  
YEAR ENDED JUNE 30, 1977**

The regulations of the Federal Office of Revenue Sharing require governments receiving revenue sharing funds to have audits of their financial statements not less than once every three years. This audit assists in fulfilling the audit requirements necessary to continue California's eligibility for federal revenue sharing funds.

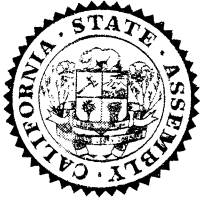
Our examination was made in accordance with generally accepted auditing standards and included studying and evaluating the Department's system of internal control. This study and evaluation disclosed several conditions which we believe to be weaknesses and were considered in determining the nature, timing, and extent of our audit tests. Presentation of these conditions, however, does not modify our opinion on the financial statements.

REPORT TO THE  
CALIFORNIA LEGISLATURE

REPORT OF THE  
JOINT REVENUE SHARING TASK FORCE  
TO THE  
JOINT LEGISLATIVE AUDIT COMMITTEE  
AND THE  
DEPARTMENT OF FINANCE

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FINANCIAL AUDIT REPORT  
STATE BANKING DEPARTMENT  
YEAR ENDED JUNE 30, 1977



# Joint Legislative Audit Committee

OFFICE OF THE AUDITOR GENERAL

## California Legislature



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October 19, 1978

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The Honorable Speaker of the Assembly  
The Honorable President pro Tempore of the Senate  
The Honorable Members of the Senate and the  
Assembly of the Legislature of California

Members of the Legislature:

Your Joint Legislative Audit Committee respectfully forwards the Auditor General's financial audit of the State Banking Department. This audit is in response to the regulations of the Federal Office of Revenue Sharing requirement that governments receiving revenue sharing funds have audits of their financial statements not less than once every three years. This audit assists in fulfilling the audit requirements necessary to continue California eligibility for federal revenue sharing funds.

The Department is in general agreement with most of the findings and is complimentary of our staff in its response.

Respectfully submitted,


  
RICHARD ROBINSON  
Chairman, Joint Legislative  
Audit Committee

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## INTRODUCTION

In compliance with regulations promulgated by the Federal Office of Revenue Sharing, we have conducted a fiscal audit of the State Banking Department. This audit was conducted under the authority vested in the Auditor General by Government Code Section 10527 and in the Department of Finance by Government Code Section 13294.

The State Banking Department is primarily concerned with protecting the public from economic loss resulting from bank and trust company failures. In addition to encouraging observance of sound banking practices, the Department regulates transmitters of money abroad and certifies securities as legal investments. The Department has recently had two new programs added to its list of responsibilities: regulation of Business and Industrial Development Corporations and administration of the Small Business Term Loan Program. The programs of the State Banking Department were supported in the past solely by the State Banking Fund (a special revenue fund). The Small Business Term Loan Program, which started July 1, 1977, is funded by the General Fund (\$1,000,000) and the State Banking Fund (\$100,000).

The State Banking Fund is replenished annually by assessment of banks and trust companies, license and application fees and charges for specific services. The assessment formula and fee structure were changed in 1977 to more closely reflect actual costs, enable the Department to replenish the Banking Fund and provide a three-month reserve.

AUDITOR'S OPINION

To the Joint Legislative Audit Committee of the California Legislature  
and the Department of Finance:

We have examined the combined balance sheet of the State Banking Department as of June 30, 1977, and the related statements of revenues, expenditures and changes in fund balance for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Because of inadequate supporting records, we were unable to obtain sufficient evidence to form an opinion regarding the General Fixed Assets account group amounting to \$74,918 at June 30, 1977. Accordingly, we do not express an opinion on the General Fixed Assets account group.

In our opinion, except as stated in the preceding paragraph, these financial statements present fairly the financial position of the State Banking Department at June 30, 1977, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The column amounts on the accompanying combined balance sheet captioned "Total - Memorandum Only" for June 30, 1977, are not necessary for a fair presentation of the financial statements, but are presented as additional analytical data and in our opinion, are fairly stated in all material respects in relation to the financial statements taken as a whole.

The column amounts on the accompanying combined balance sheet and statement of revenues, expenditures and changes in fund balance for the year ended June 30, 1976, which are presented for comparative purposes only, were not audited by us and accordingly we do not express an opinion on them.

In connection with our examination, we also made a study and evaluation of the State Banking Department's system of internal accounting control. Our findings are set forth in this report under the heading "Comments and Recommendations."

Revenue Sharing Task Force



John H. Williams, CPA  
Auditor General

Date: July 28, 1978

Staff: Curt Davis, CPA  
Michael C. Dendorfer  
Arthur G. Rogers  
Phillip Jelicich  
Richard Sanchez

STATE BANKING DEPARTMENT  
 COMBINED BALANCE SHEET  
 ALL FUND TYPES AND ACCOUNT GROUPS

JUNE 30, 1977  
 (With Unaudited Amounts for 1976)

ASSETS	Governmental Fund State Banking Fund	Fiduciary Fund Trust Account	Account Group General Fixed Assets	TOTAL (Memorandum Only)	
				June 30, 1977	June 30, 1976
Cash	\$ 53,897			\$ 53,897	\$ 52,316
Security Guaranty Deposits Held in Trust for Banks		\$63,115,500		63,115,500	61,367,500
Deposits in Surplus Money Investment Fund	945,000			945,000	299,000
Accounts Receivable	56,557			56,557	47,600
Due From Surplus Money Investment Fund	46,638			46,638	32,966
Due from other Funds	27,500			27,500	27,500
Prepayment to Service Revolving Fund	17,091			17,091	3,729
Expense Advances to Employees	13,583			13,583	12,300
Equipment (Note 5)			\$74,918	74,918	74,918
TOTAL ASSETS	<u>\$1,160,266</u>	<u>\$63,115,500</u>	<u>\$74,918</u>	<u>\$64,350,684</u>	<u>\$61,917,829</u>
<u>LIABILITIES, ENCUMBRANCES OUTSTANDING, AND FUND EQUITY</u>					
Liabilities:					
Accounts Payable (Note 2)	\$ 68,000			\$ 68,000	\$ 29,176
Encumbrances Outstanding (Note 3)	<u>59,286</u>			<u>59,286</u>	<u>175,679</u>
Fund Equity:					
Investment in General Fixed Assets			\$74,918	74,918	74,918
Reserve for Deferred Accounts Receivable (Note 4)	23,782			23,782	23,390
Fund Balance:					
Undesignated	1,009,198			1,009,198	247,166
Designated for Protection of Private and Court Trusts		<u>63,115,500</u>		<u>63,115,500</u>	<u>61,367,500</u>
TOTAL FUND EQUITY	<u>1,032,980</u>	<u>63,115,500</u>	<u>74,918</u>	<u>64,223,398</u>	<u>61,712,974</u>
TOTAL LIABILITIES, ENCUMBRANCES OUTSTANDING AND FUND EQUITY	<u>\$1,160,266</u>	<u>\$63,115,500</u>	<u>\$74,918</u>	<u>\$64,350,684</u>	<u>\$61,917,829</u>

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

STATE BANKING DEPARTMENT  
STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES  
IN FUND BALANCE - BUDGET AND ACTUAL  
STATE BANKING FUND

FOR THE FISCAL YEAR ENDED JUNE 30, 1977  
(with unaudited amounts for 1976)

	1977		1976
	Budget As Adjusted	Actual	Actual
		Over (Under) Budget	
<u>Sources of Financial Resources:</u>			
Revenues:			\$1,879,383
Assessments of Banks	\$4,093,589	\$ 3,112	199,567
Licenses and Application Fees	210,000	22,507	84,256
Income from Surplus Money Investments	100,000	2,972	5,556
Miscellaneous	<u>6,000</u>	<u>(555)</u>	<u>2,168,762</u>
Total Revenues <sup>a/</sup>	4,409,589	28,036	
Other Sources:			57,851
Reimbursements	<u>81,204</u>	<u>(10,912)</u>	<u>2,226,613</u>
Total Sources of Financial Resources	<u>4,490,793</u>	<u>17,124</u>	
<u>Uses of Financial Resources:</u>			
Expenditures:			
Current:			
Personal Services	2,983,644	( 22,309)	2,420,359
Office Expenses	123,721	( 6,315)	98,326
Communications	63,750	( 2,421)	47,936
Travel	274,020	(11,900)	247,962
Legal Fees	43,500	(14,774)	11,743
Data Processing	23,500	( 557)	13,571
Consultant Services	113,000	(33,017)	9,930
Facilities Expense	113,984	( 481)	107,972
Administrative Charges allocated from the Business and Transportation Agency Equipment	199,448	( 744)	147,425
	17,500		19,217
Prior Year:			
Prior Year Appropriation Adjustments	<u>(117,663)</u>	<u>(117,663)</u>	<u>30,997</u>
Total Uses of Financial Resources	<u>\$3,956,067</u>	<u>\$(210,181)</u>	<u>3,155,438</u>
Net Increase (Decrease) in Fund Balance During the Year		762,031	(928,825)
Fund Balance - July 1		<u>247,167</u>	<u>1,175,992</u>
Fund Balance - June 30		<u>\$1,009,198</u>	<u>\$ 247,167</u>

<sup>a/</sup> Revenues are not included in the legislative budget bill. The amounts shown on this statement are agency budgeted revenue amounts that are shown in the Governor's annual budget.

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



STATE BANKING DEPARTMENT  
STATE BANKING FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 1977

1. Summary of Significant Accounting Policies

The preceding financial statements reflect the financial position and results of operation of the State Banking Department. The accounts are maintained in the State Banking Fund and the Trust Account for securities held as guaranty deposits.

The accounting policies of the State Banking Department conform to generally accepted accounting principles as applicable to governmental units and as contained in the State Administrative Manual.

State Banking Fund

The purpose of the State Banking Fund is to account for amounts received and disbursed in connection with the regulation of banks and trust companies under the supervision of the Department and national banking associations that operate trust departments in the State.

Income: Throughout the fiscal year, income is accounted on a cash basis, except for appropriation reimbursements which are recorded when billed. At June 30, the accounts are adjusted to a modified accrual basis. All earned but uncollected revenues and unbilled reimbursements are accrued, except revenue receivables estimated not collectible within one year, which are fully reserved.

Expenditures: During the fiscal year, expenditures are accounted on a claim filed (with the State Controller) basis. Valid expenditure commitments are accrued at June 30.

#### Trust Account

The Trust Account is a depository for securities received as collateral pledges from banks accepting funds from private and court trusts. The security deposits are required to protect the trusts against loss in the event of insolvency of a depository bank.

#### Liabilities

Retirement Plan: Regular employees of the State Banking Department are members of the Public Employees' Retirement System (PERS) which is a defined benefit, contributory retirement plan. The amount the agency and employees contribute to PERS is actuarially determined under a program in which contributions plus retirement system earnings provide the necessary funds to pay retirement costs as accrued. Retirement contributions for the year included in the expenditures-personal services account were \$97,057.

Vacation and Sick Leave: The Department does not record the costs of vacation and sick leave at the time the benefits are accumulated. At the time of usage, the expenditures-personal services account is charged.

General Fixed Assets: Purchases of equipment are recorded as expenditures in the year of acquisition. The aggregate cost, with the exception of certain non-expendable equipment items not on the State Ad-

~~ministrative~~ Manual equipment list, is capitalized in the General Fixed Assets account group. Non-expendable equipment, generally valued at \$150 or over with a useful life of two years or more, is recorded at original cost or, if not available, at fair market value.

2. Accounts Payable

Accounts payable include all unpaid liabilities for goods and services received as of June 30, 1977. Accordingly, they also include liabilities for which disbursement requests were submitted to the State Controller by June 30, 1977, but which were unpaid by the State Controller as of that date.

3. Encumbrances Outstanding

Encumbrances outstanding include all valid commitments against budget appropriations for which no goods or services had been received by June 30.

4. Reserve for Deferred Accounts Receivable

The \$23,782 shown as deferred accounts receivable at June 30, 1977, consists of \$16,544 in receivables subject to collection pursuant to bankruptcy proceedings, and \$7,238 in revenue receivables.

5. General Fixed Assets Account Group

The agency has not maintained an adequate record of its general fixed assets. Subsidiary records have not been updated since 1975 and the

aggregate amount disagrees with the general ledger equipment account by approximately \$30,000. A physical inventory will be required to reconcile the two amounts..

## COMMENTS AND RECOMMENDATIONS

### Internal Accounting Control

As part of our examination, we made a study of the State Banking Department's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards, the purposes of such evaluation are to establish a basis for reliance on the system of internal accounting control in determining the nature, timing and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to (1) the safeguarding of assets against loss from unauthorized use or disposition and (2) the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstood instructions, mistaken judgment, carelessness or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can

be circumvented by collusion. Similarly, control procedures can be circumvented intentionally by management either with respect to executing and recording transactions or with respect to the estimates and judgments required in preparing financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions and that the degree of compliance with the procedures may deteriorate.

Our examination of the financial statements made in accordance with generally accepted auditing standards, including the study and evaluation of the State Banking Department's system of internal accounting control for the year ended June 30, 1977, that was made for the purposes set forth in the first paragraph of this report, would not necessarily disclose all weaknesses in the system because it was based on selective tests of accounting records and related data. However, such study and evaluation disclosed the following conditions that we believe to be weaknesses.

#### Accounting Records Are Not Kept Current

The accounting records are not kept current as required by the State Administrative Manual (SAM) section 7110. The records are up-dated periodically and at the start of our audit, during April 1978, the records were only posted through November 1977. The above condition can result in errors going undetected for protracted periods.

Recommendation: The workload of the accounting office be analyzed to determine if the work could be better organized or if a staff

increase is necessary. This analysis should result in changes that can bring the Department's records into compliance with SAM section 7110.

#### Financial Statement Procedures Are Incorrect

The pre-closing trial balance was not prepared properly per SAM section 7961 as it did not contain the year-end adjusting entries. The following reports required by SAM section 7960 were not submitted for the State Banking Fund:

- Listings of year-end Accounts Receivable and Accounts Payable
- Reconciliation of agency accounts with transactions per the State Controller.

Recommendation: The Department prepare the pre-closing trial balance in accordance with SAM section 7961 and submit all the reports required by SAM section 7960.

#### Accounting Controls Over Cash Are Inadequately Separated

The internal accounting control over cash from the point of receipt through disbursement is not in compliance with SAM section 8080. The Department's weaknesses over cash transactions are:

- The person authorizing disbursements also initiates and prepares invoices in addition to signing the checks
- The person preparing the checks also mails or distributes the signed checks
- The person receiving and depositing remittances also reconciles the bank account in addition to posting subsidiary ledgers.

Recommendation: Separate the duties over cash in accordance with SAM section 8080.

Funds Enroute to the Bank Are Inadequately Safeguarded

The Department does not safeguard funds enroute to the bank as required by SAM section 8030.4. Currently, an employee takes an envelope to the bank. The amount of deposits can total several hundred thousands of dollars a day on occasion, which is large enough to warrant a courier service.

Recommendation: The Department comply with SAM section 8030.4 by using a courier service to transport funds to the bank when the deposit amounts are large enough to warrant such a service.

Advances to Employees Are Inadequately Controlled

The Department does not maintain adequate documentation for salary advances. Outstanding travel advances are not confirmed at the end of the fiscal year as required by SAM section 8116.

Recommendation: The Department maintain adequate documentation for salary advances and confirm outstanding travel advances as required by SAM section 8116.

Year-End Accounts Payable Are Inadequately Documented

The Department's year-end Accounts Payable figures are not supported by any documentation. They are based solely on past experience. This procedure is not in compliance with SAM section 7960 which requires accounts payable to be supported by a listing of each vendor, estimate number and description of the accounts making up the accounts payable balance.



Recommendation: The Department follow the requirements of SAM section 7960 in establishing year-end accounts payable.

Separation of Duties Over Personnel Transactions Is Inadequate

SAM section 8580.1 states that the person who is authorized to receive and/or distribute salary warrants cannot process or sign any of the nine personnel documents required for the State's personnel transaction system. One employee in the Department receives and distributes the salary warrants and processes all the necessary personnel documentation.

Recommendation: The Department comply with SAM section 8580.1 and delegate some of the personnel duties, especially the handling of payroll warrants, to someone outside the accounting office.

Payroll Attendance Reports Are Not Always Filled Out Properly

Payroll Attendance Report Form 672 (State Controller's Attendance Report) does not always contain information on sick leave or vacation absences.

Recommendation: The Department post all sick leave and vacation absences to the State Controller's Attendance Report Form 672.

Accounting Controls Over Property Are Inadequate

The internal accounting controls over the acquisition, disposition, care and recordation of property are not in compliance with SAM section 8600.

Recommendation: Specific responsibility be assigned for the control over acquisition, disposition, care and recordation of property in

compliance with SAM section 8600.

### Accounting Controls Over Guaranty Deposits Are Inadequate

The current internal accounting controls over private and court trust deposits do not provide for accountability in compliance with SAM sections 7110 and 7960. The accounting office is not preparing financial statements reporting the financial condition of the security deposits.

Recommendation: Specific responsibility be assigned to someone in the Department for management, record-keeping and financial reporting of these security deposits in compliance with SAM sections 7110 and 7960.

The foregoing conditions were considered in determining the nature, timing and extent of audit tests to be applied in our examination of the financial statements, and this report of such conditions does not modify our opinion on such financial statements.

### AUDIT ADJUSTING ENTRIES

To assist in the fair presentation of the financial statements, we made several adjusting entries. The accounts affected by these entries are:

- Cash
- Deposits in Surplus Money Investment Fund
- Due from Surplus Money Investment Fund
- Accounts Payable
- Expense Advances to Employees

- Encumbrances Outstanding
- Fund Balance

The adjustments were necessary to correct the Department's accrual entries. The Department concurred with the suggested journal entries and accordingly adjusted the financial records to reflect these adjustments.



*State of California*

**STATE BANKING DEPARTMENT**

San Francisco, California

October 12, 1978

John H. Williams, Auditor General  
Office of the Auditor General  
925 L Street, Suite 750  
Sacramento, California 95814

Re: Financial Audit 1976/77

Dear Mr. Williams:

Thank you for your letter of October 3, 1978, enclosing copies of your draft report of the recently completed financial audit of the State Banking Department for the year ended June 30, 1977. We have reviewed the report and are in general agreement with most of your findings.

The Administrative support staff of the Department consists of one (1) Accounting Technician, one (1) Personnel Assistant, one (1) Staff Services Analyst and one half (1/2) of an Office Assistant II (Typing) and one (1) Accounting Officer III who oversees all of the functions listed below and acts as the Department's Administrative Officer. This staff provides the Department with all accounting, personnel, and budget functions as well as administers affirmative action, training, employee/employer relations and information practices to name a few.

Insufficient staff to allow for the proper separation of duties and the workload assigned to each have had a direct effect on several of the items mentioned in your report, however in response we submit the following.

Accounting Records Not Kept Current

The employee who previously occupied the class of Accounting Technician retired in May 1978. That person was not able to do all of required daily accounting, as well as perform the monthly accounting cycle and reconciliations. The employee hired to replace that person appears to have the capacity and the ability to perform all of the accounting through the reconciliations. We anticipate that after a six month training process that person will be able to keep the accounting records current.

### Financial Statement Procedures Are Incorrect

We will prepare the pre-closing trial balance in accordance with SAM 7961. The reports required by SAM Section 7960 will be submitted for the year ended 6/30/78.

### Accounting Controls Over Cash Are Inadequately Separated

The person authorizing disbursements only initiates and prepares invoices once during the year. This person runs the computer program that determines the bank's assessment amount and prints it on sequentially numbered invoices. The data on which the assessment amount is based is taken from bank Call Reports and entered into the terminal by a clerk. Upon completion of the tab run, the invoices are given to the accounting office for spot checking, posting and mailing. In the future we will have another employee in the Department run the program.

The person preparing the checks will no longer mail them. That responsibility will be delegated to the one half time clerical assigned to the Administrative Office.

The person receiving and depositing remittances will have to continue reconciling the bank account and posting the ledger, as there is no one to which this can be delegated since we have only one accounting person.

### Funds Enroute To The Bank Are Inadequately Safeguarded

The Department will investigate the cost of a courier service. However, during the last 15 months only 12 of 63 deposits contained cash; the largest being \$24.00. The total cash deposited during these 15 months was \$89.00.

Advances to employees are inadequately controlled. We will prepare a form to be signed by employees requiring a salary advance. Every effort will be made to confirm outstanding travel advances on June 30 as required by SAM Section 8116, however the workload on the one accounting person is very heavy.

### Year-End Accounts Payable Are Inadequately Documented

The year-end accounts payable were not supported by formal documentation, however amounts were not based on past experience. The Accounting Officer did go through the open estimates to determine the accounts payable, but did not make a formal report. We will formalize future lists of accounts payable.

### Separation Of Duties Over Personnel Transactions Is Inadequate

Currently the Personnel Assistant who prepares personnel documents distributes payroll warrants. We will be reassigning the distribution of warrants to comply with SAM 8580.1.

Payroll Attendance Reports Are Not Always Filled Out Properly

We will post absence requests to Form 672 in addition to Form 642 currently posted.

Accounting Controls Over Property Are Inadequate

We have already began working on our property inventory starting with our San Diego Office. Due to lack of staff we estimate that it will take us about a year to complete our inventory records etc. in accordance with SAM 8600.

Accounting Controls Over Guaranty Deposits Are Inadequate

This section is apparently directed at two separate and unrelated functions of the Department; The Local Agency Security Program and the pledging of securities for faithful performance. We are not clear as to what is meant by "Guaranty Deposit" since it is not a term utilized in Division I of the California Financial Code. We presume reference is to securities held by the State Treasurer, subject to our order, which are pledged for various purposes pursuant to the Financial Code. Internal controls which are maintained by institution and function are reconciled quarterly by phone by our Sacramento office to the records of the State Treasurer in addition to the annual examination of the pledging institution. A physical verification is made by the Department annually. Under the Local Agency Security Law memo controls are kept by institution and reconciled quarterly with the Called Report of Local Agency Security deposits for collateral pledged for public deposits. The legal responsibility for the safety of the approximately \$6.5 billion in securities lies with the agents of depository and not with the Administrator of Local Agency Security.

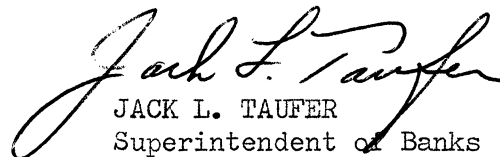
We have read the SAM Sections quoted in your report but are still unable to determine how financial statements are to be prepared.

In discussing this with our Deputy in Sacramento who is responsible for both programs he advises that he is not aware of any auditor physically reviewing the controls maintained in his office (Sacramento).

I would suggest that someone from your office contact us to set up a meeting with our Deputy in Sacramento, our Accounting Officer and myself to arrive at a solution to this problem.

We would like to express our thanks for the professional and courteous manner in which your audit team performed their duties. Both Art Rogers and Michael Dendorfer were very helpful.

Very truly yours,

  
JACK L. TAUFER  
Superintendent of Banks

JLT/jn

Office of the Auditor General

cc: Members of the Legislature  
Office of the Governor  
Office of the Lieutenant Governor  
Secretary of State  
State Controller  
State Treasurer  
Legislative Analyst  
Director of Finance  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Democratic/Republican Caucus  
California State Department Heads  
Capitol Press Corps