

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

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

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

F-904

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OVER ITS FINANCIAL OPERATIONS

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March 28, 1990

F-904

Honorable Elihu M. Harris, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 2148
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents "A Review of the State's Controls Over Its Financial Operations." Our report discusses 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 \$11.7 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.

Respectively submitted,

A handwritten signature in cursive script, appearing to read "Kurt R. Sjoberg".

KURT R. SJOBERG
Acting Auditor General

PART I

REPORT ON THE EVALUATION OF
INTERNAL CONTROLS AND THE REVIEW OF
COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS
AND STATE LAWS

TABLE OF CONTENTS

	<u>Part</u>
REPORT ON THE EVALUATION OF INTERNAL CONTROLS AND THE REVIEW OF COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS AND STATE LAWS	I
STATE OF CALIFORNIA FINANCIAL REPORT YEAR ENDED JUNE 30, 1989	II

PART II

STATE OF CALIFORNIA
FINANCIAL REPORT
YEAR ENDED JUNE 30, 1989

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	S-1
INTRODUCTION	1
CHAPTER	
I STATEWIDE CONCERNS	5
II SUMMARY OF AUDIT RESULTS BY AREA OF GOVERNMENT	25
Business, Transportation and Housing	29
Education	31
General Government	33
Health and Welfare	34
Legislative, Judicial, and Executive	36
Resources	37
State and Consumer Services	38
Youth and Adult Correctional	40
REPORT ON THE STUDY AND EVALUATION OF INTERNAL CONTROL	41
DETAILED DESCRIPTION OF WEAKNESSES AT STATE AGENCIES	47
Index	49
Deficiencies Common to Various Agencies	53
Management Letters by Area of Government	65
REPORT ON COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS	301
SCHEDULE OF FEDERAL ASSISTANCE FISCAL YEAR ENDED JUNE 30, 1989	307
WEAKNESSES IN COMPLIANCE WITH FEDERAL REGULATIONS DISTRIBUTION BY GRANT	327

TABLE OF CONTENTS (CONTINUED)

	<u>Page</u>
REPORT ON COMPLIANCE WITH FEDERAL GRANT REQUIREMENTS (Continued)	
SCHEDULE OF AUDIT REPORTS INVOLVING FEDERAL GRANTS JULY 1, 1988 TO DECEMBER 31, 1989	331
SCHEDULE OF MINOR FEDERAL ISSUES FISCAL YEAR ENDED JUNE 30, 1989	339
REPORT ON COMPLIANCE WITH STATE LAWS AND REGULATIONS	341
APPENDICES	
A SCHEDULE OF ACTUAL AND POTENTIAL LOSSES IDENTIFIED DURING OUR REVIEW OF THE STATE'S FINANCIAL ACTIVITIES	345
B REPORTS ISSUED BY THE OFFICE OF THE AUDITOR GENERAL JULY 1, 1988 TO DECEMBER 31, 1989	347
RESPONSE TO THE OFFICE OF THE AUDITOR GENERAL'S REPORT	
Department of Finance	353

SUMMARY

STATUS OF INTERNAL CONTROLS

Although the State of California has corrected some of the internal control weaknesses that we have reported in recent years, it has many more weaknesses to correct. The State has weaknesses in its accounting, auditing, and administrative control systems that result in inaccurate financial statements; noncompliance with state and federal regulations; and the waste, loss, and misuse of state resources. For fiscal year 1988-89, each of the 21 agencies at which we reviewed internal control systems had weaknesses in the controls over their financial activities.

For the 21 agencies, we audited amounts representing approximately 60 percent of the State's revenues and approximately 62 percent of the State's spending. In addition, other independent auditors audited approximately 32 percent of the State's revenues and approximately 23 percent of the State's spending. We also reviewed selected internal control procedures at 2 agencies for fiscal year 1988-89. Further, for fiscal year 1987-88, we audited the financial operations of 5 other agencies and institutions. Finally, for fiscal year 1987-88, we audited the financial operations of 2 of the 21 agencies we audited for fiscal year 1988-89. Thus, in total, we reviewed internal control procedures at 28 state agencies and institutions.

ACTUAL AND POTENTIAL LOSSES

The State may have lost at least \$684,340 in foregone interest and discounts because the State did not promptly collect moneys owed to it or did not promptly pay invoices. Additionally, because the State does not always follow established collection procedures, it may have difficulty collecting some of approximately \$289,234 owed to it. Further, the State may have lost approximately \$3.6 million in revenues and may have incurred unnecessary expenditures of approximately \$57,862. 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 of actual and potential losses listed by state agency.

Weaknesses in the State's system of internal controls over the state agencies' use of fiscal agents to pay the agencies' expenditures out of the fiscal agents' bank accounts and over contracts for grants to local governments have contributed to losses totaling at least \$5.9 million through alleged embezzlements.

Many of the weaknesses in internal control 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 varying 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. GAAP is the preferred method of accounting because it is a nationally recognized set of accounting principles that allows the State to be compared with other states and because it 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. Furthermore, the State recognizes as revenues tax overpayments that will have to be refunded or applied to future years.

During fiscal year 1988-89, we became aware of two additional weaknesses in the State's system of internal control that contributed to the loss of state funds through alleged fraud and embezzlement. Specifically,

the State does not preclude state agencies from contracting with fiscal agents to pay invoices with state funds deposited in the fiscal agents' bank accounts at the direction of the state agencies. One agency used fiscal agents to circumvent state civil service hiring rules, state procurement rules, and state contracting rules. In addition, one employee of this agency allegedly embezzled \$821,000. Further, the State does not have adequate control over contracts for grants to local governments. The weaknesses in this area contributed to the ability of a former state employee to allegedly embezzle \$5.1 million from the State.

We also 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 combining statements by fund type in its audited financial statements, and it does not properly account for billions of dollars of fixed assets. As a result of these three weaknesses, as we reported last year, the State does not qualify for the Certificate of Achievement for Excellence in Financial Reporting. Also, the State continues to spend unnecessary additional time and effort to prepare 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 that we audited had weaknesses in internal controls over financial reporting, revenue, and expenditure activities. Additionally, we noted immaterial instances of noncompliance with state and federal regulations at several agencies. Finally, several deficiencies in internal controls were common throughout the State.

Weak Controls Over Financial Activities

Twelve of the agencies that we audited had weaknesses in their internal control systems over financial reporting. Problems that we found included incorrect or a lack of reconciliations, inappropriate accounting practices, and inadequate accounting over 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, 1988, and at June 30, 1989, by approximately \$3.8 million and \$1.3 million, respectively. This 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.

Further, 17 of the agencies that we audited had weaknesses in internal controls over revenue activities. Problems that 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, inaccurate financial statements, and loss of interest revenue. For example, because the Department of Social Services does not always properly control its cash management system for the federal government's share of the department's local assistance expenditures, it has lost approximately \$322,000 in potential interest income.

Finally, problems involving expenditure activities existed at 26 of the agencies that we audited. The problems that 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 exist in apportioning moneys to schools, distributing sales and use tax collections to local governments, and 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 local governments and the State's interests being at risk because of improper contracting.

Lack of Compliance With Federal Regulations

In fiscal year 1988-89, the State received approximately \$11.7 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 31 of the 39 grants that we reviewed.

These 39 grants represent approximately 95 percent of all federal moneys that the State received for fiscal year 1988-89, excluding the University of California. Our review showed that agencies failed to adhere to requirements for reporting, cash management, and 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 fiscal year ended June 30, 1989, we studied and evaluated the State's systems of internal control. The purpose of our study of these systems 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 21 of the 336 state agencies included in the general purpose financial statements.

Amounts that we audited at these agencies represented approximately 60 percent of the State's revenues and approximately 62 percent of the State's spending. Further, other independent auditors audited approximately 32 percent of the State's revenues and approximately 23 percent of the State's spending. In addition to this audit coverage of the State's revenues and spending, increased coverage resulted from centralized testing, that is, selecting items for review from the State as a whole rather than from the individual agencies. For example, we selected a sample of payroll warrants that the State processed through its payroll system. In addition, we selected a

sample of all 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 also reviewed selected internal control procedures at 2 agencies for fiscal year 1988-89. In addition, for fiscal year 1987-88, we audited the financial operations of 5 operating departments and institutions. We issued the audit results of these 5 operating departments and institutions after we issued the State of California Comprehensive Financial and Compliance Audit Report for the Year Ended June 30, 1988. Further, we reviewed the fiscal controls for fiscal year 1987-88 at 2 of the 21 agencies where we reviewed the fiscal controls for fiscal year 1988-89. Thus, we are including these audit results in this report. In total, we reviewed internal control procedures at 28 state agencies and institutions.

We also reviewed 27 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 budgeting, investing, collecting, and disbursing state moneys and 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 39 of the 274 federal grants that the State administers. These 39 grants represent approximately 95 percent of the federal funds that the State received in fiscal year 1988-89, excluding moneys that 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.

Included in this report are the following reports that the federal Office of Management and Budget, Circular A-128, requires the State to issue each year. These reports state the specific scope of our audit.

- Report on the systems of internal control used in preparing the general purpose financial statements and in administering federal assistance programs (begins on page 41);
- Report on weaknesses and instances of noncompliance at state agencies (begins on page 47);

- 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 301); and

- Report on compliance with state laws and regulations (begins on page 341).

Between July 1, 1988, and December 31, 1989, the Office of the Auditor General issued 45 audit reports, many of which discussed improvements needed in the State's operations. These reports, listed in Appendix B, are available to the public.

CHAPTER I
STATEWIDE CONCERNS

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. The State has inconsistently reported its financial condition, partly because it does not budget, and does not report on the past execution of the State's budget, using nationally recognized accounting principles. Moreover, the State 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). Also, the State does not ensure that the charges of internal service funds to federal programs are in compliance with federal regulations. Further, the State does not maintain adequate control over payments of invoices with state funds deposited in fiscal agents' bank accounts. 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, does not produce combining statements by fund type, and does not account for its fixed assets properly. Additionally, the State does not have a central record of state leases that contains all the information required by GAAP. Moreover, fraud and embezzlement can occur because the State does not have adequate controls over its contracts. 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 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. GAAP is the preferred method of accounting because it is a nationally recognized set of accounting principles that allows the State to be compared with other states and because it improves accountability since, under GAAP, costs are recognized when they occur.

Further, the State does not currently account for 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 has historically reported 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. In the Governor's Budget 1990-91, the governor proposed changing the method of reporting outstanding purchase orders and contracts to more closely conform to GAAP. Also, the State recognizes tax overpayments that will have to be refunded or applied to future years as revenue.

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.

	<u>Amount (in thousands)</u>
Total Fund Equity per the State Controller's Office	\$829,310
Medi-Cal Services Provided but Not Paid for	(737,907)
Earned Vacation Leave Not Paid for	(85,355)
Loans That Will Be Repaid	155,147
Goods and Services Not Received by June 30	360,546
Tax Overpayments	(409,747)
Other Adjustments	<u>(7,587)</u>
Total Fund Equity per Audited GAAP Report	<u>\$104,407</u>

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.

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 in accordance with the State's statutory and regulatory requirements (budgetary basis). This section also requires that the format of the budgetary-legal 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 and issues the general purpose financial statements in conformance with GAAP. The Department of Finance has not provided sufficient instructions in the State Administrative Manual to make the 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 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.

The State is in the process of converting from the budgetary basis to GAAP in certain areas. The Department of Finance has done work on rewriting the sections of the State Administrative Manual covering proprietary funds to bring them into conformance with GAAP. Further, the State's "Fund Manual" has been rewritten to bring it into conformance with GAAP. In addition, in the Governor's Budget 1989-90 and 1990-91, the Department of Finance treated the State's General Fund encumbrances as a reservation of fund balance rather than expenditures. This treatment is consistent with GAAP in that encumbrances are obligations for which goods and services have not been

received and that should not be shown as expenditures. This treatment could be considered one more step towards California's implementation of GAAP. However, 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 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.

FAILURE OF THE DEPARTMENT OF FINANCE TO ENSURE THAT THE CHARGES OF INTERNAL SERVICE FUNDS TO FEDERAL PROGRAMS ARE IN COMPLIANCE WITH FEDERAL REGULATIONS

The State has a possible liability to the federal government estimated to be as much as \$22.5 million for profits it has accumulated in its internal service funds between July 1, 1984, and June 30, 1989. 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, 1989, that represents charges to federal programs.

Using procedures similar to those of the Department of Finance, and using the same percentages of federal participation, we estimate that, under current federal regulations, the State may owe the federal government as much as \$22.5 million. This is the federal share of profits accumulated by three of the State's internal service funds from July 1, 1984, to June 30, 1989, after audit adjustments and undercharges to federal programs of approximately \$660,000 for the remaining 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 of federal participation that the federal government accepted in its 1984 audit for the period July 1, 1969, to June 30, 1984, is still acceptable in 1989 for the period July 1, 1984, to June 30, 1989. In addition, 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 cash expenditures. This amendment, if approved, may eliminate the liability to the federal government for one internal service fund and reduce the liability for the remaining two funds to approximately \$11.0 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, at the same time, they may be in noncompliance with the federal Office of Management and Budget, Circular A-87, "Cost Principles for State and Local Governments." Circular A-87 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. 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.

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. These sections also require departments to submit a report to the State Controller's Office, the State Treasurer's Office, and the Auditor General'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 these fiscal agents' bank accounts 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. One department, the Chancellor's Office of the California Community Colleges, used fiscal agents to circumvent state civil service hiring rules, state procurement rules, and state contracting rules. In addition, one employee allegedly embezzled \$821,000. We can find no merit in fiscal agent relationships; they circumvent rules established by various state control agencies to limit the State's risk in various areas. 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. This time requirement was established in 1980. 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 repeatedly taken over 200 days.

To address this concern, the Office of the Auditor General contracted with a consulting firm, Price Waterhouse, to evaluate the State's financial reporting system. Price Waterhouse identified shortcomings throughout the State's financial reporting system and made corresponding recommendations. In response to Price Waterhouse's recommendations, a committee consisting of representatives from various state control agencies is responsible for improving the State's reporting system. It has initiated a pilot project to make financial reporting more accurate and prompt. The project involves developing 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.

An additional reason for delays in producing audited financial statements is that the audit reports of the pension trust funds prepared by other independent auditors are not completed promptly. The audit reports for fiscal year 1988-89 for the pension trust funds were received as late as 221 days after the end of the fiscal year. The information from these reports is included in the State's general purpose financial statements. Therefore, the reports must be completed before the issuance of the State's general purpose financial statements.

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 the detail for the fund type totals shown in the general purpose financial statements. Guidelines issued by the Governmental Accounting Standards Board state 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.

The State has not prepared combining statements by fund type in accordance with the 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 while, using GAAP, we account for the same funds in the Special Revenue Fund Type.

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. Also, the State does not 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, and the State is exposed to an increased risk of loss of 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 Fixed Asset 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 a description of each major structure on the property in the statewide inventory. Although not required by the California Government Code, the Department of General Services also plans to include information on the cost of real property and structures. 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 comprise 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 act for fiscal year 1988-89 included funding to develop the statewide inventory of real property. The Department of General Services has not yet completed the statewide inventory of real property but estimates that it will complete it by June 1990.

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 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.

INSUFFICIENT REPORTING OF LEASING INFORMATION

As we reported in fiscal years 1986-87 and 1987-88, the State continues to spend unnecessary additional time and effort to prepare 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. The State's lease commitments totaled \$3.2 billion in fiscal year 1988-89. GAAP requires the State, when it leases space or equipment from outside vendors, to disclose commitments for future minimum lease and rental payments in a summary that separates these future payments by fiscal year. Although the Department of General Services maintains space and equipment lease records for many lease commitments, it established these records for its internal management purposes and did not intend the records to be a complete listing of the State's leases that would meet GAAP requirements. Thus, the records do not provide all the necessary information.

For example, the records maintained by the Department of General Services disclose only the current year payment for each lease and do not indicate how the payment will change in future years. In addition, the records do not separate future minimum lease and rental payments by fiscal year. Further, the records do not include information on certain leases for which the Department of General Services does not have oversight responsibility. For example, because the Department of General Services is not required to approve the California State Lottery Commission's leases, the department's records do not include over \$76 million in commitments that the California State Lottery Commission has entered into for its leasing of gaming terminals, data processing equipment, vehicles, and space.

Governmental accounting and reporting standards require that governmental accounting systems allow the fair presentation and full disclosure of the governmental entity's financial position and results of financial operations in accordance with GAAP. In addition, the California Government Code, Section 12460, requires the State to present its financial position as closely as possible in accordance with GAAP.

FRAUD AND EMBEZZLEMENT CAN OCCUR BECAUSE OF
INADEQUATE CONTROL OVER CONTRACTS

Grants and certain contracts and interagency agreements are not routed through the Department of General Services. Some agencies consider certain contracts to be grants and that these contracts do not

require the Department of General Services' approval. The State Administrative Manual, Section 1203, requires only those contracts and interagency agreements requiring the Department of General Services' approval to be transmitted to the Department of General Services. As a result, grants and some contracts and interagency agreements go directly from the originating agency to the State Controller's Office. The State Controller's Office does not have assurance that grants and all contracts and interagency agreements submitted are valid. This weakness would be minimized by having the Department of General Services act as a "clearing-house" for all grants, contracts, and interagency agreements. As part of the clearing house function, the Department of General Services should establish a statewide vendor list that would contain all entities that the State contracts with. 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 contracts.

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 were confused about whether these contracts were subject to the Department of General Services' approval. As a result, 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. The Attorney General's Office has determined that contracts for grants of federal funds are not required to be approved by the Department of

General Services based on present rules, and the departments' legal counsels have determined that certain contracts for grants of state funds are not required to be approved by the Department of General Services based on their interpretation of the present rules.

Whether or not a contract with a local government involves a grant of state or federal funds, we feel 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. In fact, the lack of the Department of General Services' approval on a contract with a local government for a grant of state funds contributed to the embezzlement of \$5.1 million from the State Water Resources Control Board. 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 REQUIRE ACCOUNTING
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 three 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 and, therefore, is not in compliance with federal Office of Management and Budget, Circular A-128. The schedule of federal assistance that we present, beginning on page 309, shows total receipts rather than expenditures.

The federal Office of Management and Budget, 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 reported last year, 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 part of the state reporting entity, we requested a legal opinion from the Legislative Counsel. The Legislative Counsel found that the District Agricultural Associations are state agencies and that moneys that 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
TO THE STATE CONTROLLER'S OFFICE

The State Administrative Manual, Section 7951, does not require agencies to prepare Report 15, Reconciliation of Agency Accounts With Transactions Per State Controller, for approximately 226 funds numbered 500 to 699 and 800 to 999. 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 three 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 70 that had budget appropriations for fiscal year 1988-89. As a result of not preparing the report, information that is 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 three fiscal years.

The California Government Code, Section 12460, requires the State to present its financial position as closely as possible in accordance with 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.

CHAPTER II

SUMMARY OF AUDIT RESULTS BY AREA OF GOVERNMENT

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

Table 1, which begins on page 26, 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 329. The page number column in Table 1 provides the location of our management letter for the indicated state agency. The item numbers in the other columns provide the item number of each weakness as presented in the agencies' management letters. ✓

Beginning on page 29, we present a summary of the most significant findings by area of government. At the beginning of each area of government, we present additional information regarding audit work performed.

TABLE 1

WEAKNESSES IN INTERNAL CONTROL SYSTEMS

Agency	Page Number	Weaknesses and Item Numbers ^a						
		Financial Reporting Activities	Revenue Activities	Expenditure Activities	Electronic Data Processing Activities	Internal Audit Standards	Compliance With Federal Regulations	Compliance With State Regulations
BUSINESS, TRANSPORTATION AND HOUSING								
Commerce, Department of ^c	69		1	2,3,4,5				
Stephen P. Teale Data Center ^e	72	3,4,5,6	2	6,8		1		7
Transportation, Department of	85	4	2,6	1		3,5,7		
EDUCATION								
California Community Colleges, Chancellor's Office	93	10,11		7,8,9,12		1,2,3,4,12		5,6,
California State University	107			1,2				
California Student Aid Commission	110		1			2,3,4,5,6		
Education, State Department of	115	1	2,4,17	1,2,3,17		6,7,8,9,10,11,12,13,14,15,16		5,17
GENERAL GOVERNMENT								
Agricultural Labor Relations Board	137	1		2				
Criminal Justice Planning, Office of	139						1	
Economic Opportunity, Department of	140		2	3				1
Finance, Department of	144						1,2,3	
Food and Agriculture, Department of	147							1

Footnotes are presented on page 28.

Weaknesses and Item Numbers^a

<u>Agency</u>	<u>Page Number</u>	<u>Financial Reporting Activities</u>	<u>Revenue Activities</u>	<u>Expenditure Activities</u>	<u>Electronic Data Processing Activities</u>	<u>Internal Audit Standards</u>	<u>Compliance With Federal Regulations</u>	<u>Compliance With State Regulations</u>
HEALTH AND WELFARE								
Aging, Department of	151			2			1	
Alcohol and Drug Programs, Department of	153			5			1,2,3,4	
Employment Development Department	159		1		1		2,3,4,5	
Health and Welfare Agency Data Center	165	2	2	2			1	
Health Services, Department of	169		6,12,13,14	5,15			1,2,3,4 7,8,9,10 11,12,15	
Mental Health, Department of	184	4	3	5			1,2	6 ^d
Rehabilitation, Department of	189			3		4	1,2,3	
Social Services, Department of	194	2,18	3,4	1,16,18			4,5,6,7,8 9,10,11,12 13,14,15,19	17 ^d ,18
LEGISLATIVE, JUDICIAL, AND EXECUTIVE								
Emergency Services, Office of	225						1,2,3,4,5	
Equalization, Board of	228			2	1			3 ^d
Justice, Department of	232					1		
State Controller's Office	234		1	1				
RESOURCES								
Forestry and Fire Protection, Department of	239		4	5			1,2,3,6	
Parks and Recreation, Department of	244					1,2,3		
Water Resources, Department of	247	1		1				

Footnotes are presented on page 28.

Weaknesses and Item Numbers ^a								
Agency	Page Number	Financial Reporting Activities	Revenue Activities	Expenditure Activities	Electronic Data Processing Activities	Internal Audit Standards	Compliance With Federal Regulations ^b	Compliance With State Regulations
STATE AND CONSUMER SERVICES								
Franchise Tax Board	253		1,2,3					
General Services, Department of	264	2,3,7,9,10	5,6	4,8,10			1	
State Personnel Board ^c	280	4	1	1,2,3,4				
YOUTH AND ADULT CORRECTIONAL								
Corrections, Board of	287			1				
Corrections, Department of California State Prison at Folsom ^c	288			1				
Mule Creek State Prison ^c	290 292		3	1,2,3 1,2,3,4,5,6				
Youth Authority, Department of the	296			1,4				2,3

^aThe item number is the number of each weakness as presented in the state agencies' management letters.

^bThe table on page 327 provides more detail regarding the weaknesses in compliance with federal regulations.

^cWe audited the financial operations of these agencies for fiscal year 1987-88; however, we issued the audit results after we issued the State of California Comprehensive Financial and Compliance Audit Report, Year Ended June 30, 1988.

^dThese items represent deficiencies in administering state contracts. Table 2 on page 56 provides further detail of these deficiencies.

^eWe reviewed the fiscal controls of these agencies for fiscal years 1987-88 and 1988-89.

BUSINESS, TRANSPORTATION AND HOUSING

In fiscal year 1988-89, the State spent over \$4.4 billion, approximately 6 percent of the State's expenditures, on programs in the Business, Transportation and Housing Agency. The agency oversees the operations of 18 departments and other budgeted activities. In addition to the audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on 4 departments: the Department of Commerce, the Department of Motor Vehicles, the Stephen P. Teale Data Center, and the Department of Transportation. Also, we audited one federal program with receipts of approximately \$1.1 billion for compliance with federal regulations. Further, we have issued 12 special topic reports that include issues relating to Business, Transportation and Housing programs since July 1988. These special topic reports required our office to review the selected operations of one additional department: the Department of Insurance. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

We reported weaknesses for 3 departments within the Business, Transportation and Housing Agency. In the following section, we discuss the most significant weakness that we reported.

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 did not reconcile the results of its fiscal year 1987-88 physical inventory of equipment located in the Sacramento area with its general ledger equipment account balance. Nor does the data center maintain a comprehensive inventory listing of equipment that it has retired from use and stored in its warehouse. Further, the data center did not always comply with state regulations in identifying and attaching a tag with a state identification number to equipment that it purchases. 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.

Additionally, the data center's weaknesses in accounting for equipment and intangible assets resulted in incorrect account balances. Specifically, the data center overstated the equipment balance when it did not remove from the balance at June 30, 1988, and June 30, 1989, items of equipment valued at approximately \$3.8 million and \$1.3 million, respectively, that it sold or removed from service before the end of the fiscal year. The data center also overstated expenses and understated intangible assets because it recorded the cost 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.

As of June 30, 1989, the data center had not recorded software purchases of approximately \$3.3 million as intangible assets.

EDUCATION

In fiscal year 1988-89, the State spent over \$34.6 billion, approximately 46 percent of the State's expenditures, on education programs. This area of government consists of 15 departments and other budgeted activities. In addition to the audits performed by other independent auditors and our centralized testing, 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 State Department of Education. Also, we audited 12 federal programs with receipts of approximately \$1.5 billion and other independent auditors audited one federal program with receipts of approximately \$74.0 million for compliance with federal regulations. Further, we have issued seven special topic reports that include issues relating to education programs since July 1988. These special topic reports required our office to review the selected operations of two additional entities: the California Maritime Academy and the California State University, Long Beach. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

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

State Department of Education

The State Department of Education (department) inaccurately calculated and classified certain expenditure and liability accruals for the State Legalization Impact Assistance Fund. Specifically, the department incorrectly calculated and, thus, understated an accrual of assets, liabilities, revenues, and expenditures for the State Legalization Impact Assistance Fund by approximately \$8.0 million. Further, the department incorrectly classified as accounts payable approximately \$54.3 million of amounts due to other governments and approximately \$900,000 of amounts due to other funds in its financial reports.

California Student Aid Commission

The California Student Aid Commission (commission) did not have a system to detect errors in federal reimbursements for its payments to lenders on defaulted student loans. As a result, the commission did not detect an error the federal government made when it underpaid the commission by approximately \$875,000. The federal government subsequently paid the commission the \$875,000 when we detected the error. According to the commission's chief of

administrative services, the commission plans to implement a new financial aid processing system that will include a system to review federal reimbursements.

GENERAL GOVERNMENT

In fiscal year 1988-89, the State spent over \$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 audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on 5 departments: the Agricultural Labor Relations Board, the Office of Criminal Justice Planning, the Department of Economic Opportunity, the Department of Finance, and the Department of Food and Agriculture. Also, we audited two federal programs with receipts of approximately \$106.7 million for compliance with federal regulations. Further, we have issued eight special topic reports that include issues relating to general government since July 1988. These special topic reports required our office to review the selected operations of seven additional entities: the California Arts Council, the California Exposition and State Fair, the California Horse Racing Board, the Department of Industrial Relations, the Military Department, the Public Utilities Commission, and the State Compensation Insurance Fund. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

We reported weaknesses for 5 of the departments that we audited within the area of general government. See Table 1 on page 26 for the classification of these weaknesses.

HEALTH AND WELFARE

In fiscal year 1988-89, the State spent over \$23.9 billion, approximately 33 percent of the State's expenditures, on programs in the Health and Welfare Agency. The agency oversees the operations of 17 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. Also, we audited 22 federal programs with receipts of approximately \$8.4 billion for compliance with federal regulations. Further, we have issued 15 special topic reports that include issues relating to Health and Welfare Agency programs since July 1988. 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, 1988, to December 31, 1989).

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

Department of Health Services

The Department of Health Services (department) has numerous weaknesses in its administration of the federal Special Supplemental Food Program for Women, Infants and Children, the Medical Assistance Program, and the State Legalization Impact Assistance Grants. For example, the department was late in reconciling approximately 72 percent of issued food vouchers with food vouchers redeemed in fiscal year 1988-89 for the Special Supplemental Food Program for Women, Infants and Children. Additionally, the department overpaid Medi-Cal providers for certain claims for office visits by Medi-Cal beneficiaries because of a deficiency in the computer system that processes claims. Further, the department's Primary Health Care Systems Branch did not approve agreements with nonprofit providers of primary care services funded by the State Legalization Impact Assistance Grants until after the nonprofit agencies began providing services.

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 government's share of the department's expenditures. For example, the department did not ensure that federal funds were available before it submitted claim schedules to the State Controller's Office for payment. The State Controller's Office returned two claim schedules totaling approximately \$1.2 million because of insufficient spending authority in the department's Federal Trust Fund. As a result, the department delayed payments to counties for almost 360 days. In addition, the department did not promptly request federal funds to reimburse the State for local assistance expenditures, resulting in the loss of approximately \$322,000 in potential interest income. Finally, the department requested federal funds in excess of the department's needs for the Social Security-Disability Insurance Program for the first six months of fiscal year 1988-89. Requesting federal funds in excess of the department's needs may result in the termination of advance financing by the federal government.

LEGISLATIVE, JUDICIAL, AND EXECUTIVE

In fiscal year 1988-89, the State spent over \$1.3 billion, approximately 2 percent of the State's expenditures, on the legislative, judicial, and executive area of government. This area of

government consists of 42 departments and other budgeted activities. In addition to the audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on 5 departments: the Office of Emergency Services, the Board of Equalization, the Department of Justice, the State Controller's Office, and the State Treasurer's Office. Also, we audited three federal programs with receipts of approximately \$104.6 million for compliance with federal regulations. Further, we have issued four special topic reports that include issues relating to the legislative, judicial, and executive areas of government since July 1988. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

We reported weaknesses for 4 departments within the legislative, judicial, and executive areas of government. See Table 1 on page 26 for the classification of these weaknesses.

RESOURCES

In fiscal year 1988-89, the State spent over \$1.9 billion, approximately 3 percent of the State's expenditures, on programs in the Resources Agency. The agency oversees the operations of 25 departments and other budgeted activities. In addition to the audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on 4 departments: the Department of Forestry and Fire Protection, the Department of Parks and Recreation,

the State Lands Commission, and the Department of Water Resources. Also, we audited one federal program with receipts of approximately \$25.7 million for compliance with federal regulations. Further, we have issued one special topic report that included issues relating to programs in the Resources Agency since July 1988. This special topic report required our office to review the selected operations of two additional entities: the California Waste Management Board and the State Water Resources Control Board. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

We reported weaknesses for 2 departments within the Resources Agency. See Table 1 on page 26 for the classification of these weaknesses.

STATE AND CONSUMER SERVICES

In fiscal year 1988-89, the State spent over \$1.9 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 the audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on 4 departments: the Contractors' State License Board, the Franchise Tax Board, the Department of General Services, and the State Personnel

Board. Also, we have issued three special topic reports that include issues relating to programs for the State and Consumer Services Agency since July 1988. These special topic reports required our office to review the selected operations of two additional entities: the Department of Veterans Affairs and the State Board of Barber Examiners. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

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

Franchise Tax Board

The Franchise Tax Board (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, in some cases, they are legally entitled to receive. In addition, the board's executive management has not developed a complete time frame to implement corrective action for all critical and noncritical weaknesses that were identified. Therefore, the board has no assurance that critical weaknesses will be resolved promptly.

YOUTH AND ADULT CORRECTIONAL

In fiscal year 1988-89, the State spent over \$2 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 the audits performed by other independent auditors and our centralized testing, our financial and compliance audit focused on five entities: the Board of Corrections, the Department of Corrections, the Department of the Youth Authority, California State Prison at Folsom, and Mule Creek State Prison. Also, we have issued five special topic reports that include issues relating to programs for the Youth and Adult Correctional Agency since July 1988. These special topic reports required our office to review the selected operations of three additional entities: the Board of Prison Terms; the Correctional Training Facility, Soledad; and the Sierra Conservation Center. (Appendix B lists the reports that the Office of the Auditor General issued from July 1, 1988, to December 31, 1989).

We reported weaknesses for three departments and two institutions within the Youth and Adult Correctional Agency. See Table 1 on page 26 for the classification of these weaknesses.

REPORT ON THE STUDY AND EVALUATION
OF INTERNAL CONTROL



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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, 1989, and have issued our report thereon dated December 22, 1989. We did not examine the financial statements of the pension trust funds, which reflect total assets constituting 78 percent of the fiduciary funds. We also did not examine the financial statements of certain enterprise funds, which reflect total assets and revenues constituting 91 percent and 96 percent, respectively, of the enterprise funds. In addition, we did not examine the University of California funds. We did not examine the financial statements of these pension trust funds, enterprise funds, and University of California funds because they were examined 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. These 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. Also, as part of our audit, we made a study and evaluation of the State's internal control systems, including applicable internal administrative controls, used in administering federal financial assistance programs to the extent we considered necessary to evaluate the systems as required by the Single Audit Act of 1984 and the provisions of the federal Office of Management and Budget, Circular A-128, Audits of State and Local Governments.

In planning and performing our audit of the general purpose financial statements of the State of California for the year ended June 30, 1989, we considered its internal control structure to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance regarding the internal control structure.

For the purpose of this report, we have classified the systems of internal control of the State into three areas: financial activities, including electronic data processing controls; state compliance; and federal compliance. We did not study the systems of internal control for the pension trust funds, certain enterprise funds, and the University of California funds.

The Department of Finance and the management of the agencies are responsible for establishing and maintaining an internal control structure, including applicable internal administrative controls used in administering federal financial assistance programs. In fulfilling this responsibility, estimates and judgements 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 and 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. Also, the objectives of the applicable internal administrative controls used in administering federal financial assistance programs are to provide management with reasonable, but not absolute, assurance that, with respect to federal financial assistance programs, resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

Because of inherent limitations in any internal control structure, including the system of accounting and administrative controls used in administering federal financial assistance programs, errors or irregularities 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 the policies and procedures or the degree of compliance with the procedures may deteriorate.

Our study included all of the applicable controls in the three systems noted above. For these systems, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk. During the year ended June 30, 1989, the State received 95 percent of its total federal financial assistance under major federal financial assistance programs. With respect to internal control systems used in administering major federal financial assistance programs, our study and evaluation included considering the types of errors and irregularities that could occur, determining the internal control procedures that should prevent or detect such errors and irregularities, determining whether the necessary procedures are prescribed and are being followed satisfactorily, and evaluating any weaknesses.

With respect to the internal control systems used solely in administering the nonmajor federal financial assistance programs of the State, our study and evaluation was limited to a preliminary review of the systems to obtain an understanding of the control environment and the flow of transactions through the accounting system. Our study and evaluation of the internal control systems used solely in administering

the nonmajor federal financial assistance programs of the State did not extend beyond this preliminary review phase.

Our study and evaluation was more limited than would be necessary to express an opinion on the internal control systems used in administering the federal financial assistance programs of the State. Accordingly, we do not express an opinion on the internal control systems used in administering the federal financial assistance programs of the State. Further, we do not express an opinion on the internal control systems used in administering the major federal financial assistance programs of the State. Also, our audit, made in accordance with the standards mentioned above, would not necessarily disclose material weaknesses in the internal control systems used solely in administering nonmajor federal financial assistance programs. However, we noted a 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. 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.

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

A handwritten signature in black ink, appearing to read "Curt Davis", is written over the typed name.

CURT DAVIS, CPA
Deputy Auditor General

February 23, 1990

DETAILED DESCRIPTION OF WEAKNESSES AT STATE AGENCIES

INDEX

	<u>Page</u>
DEFICIENCIES COMMON TO VARIOUS AGENCIES	53
MANAGEMENT LETTERS BY AREA OF GOVERNMENT	65
<u>Business, Transportation and Housing</u>	
Commerce, Department of	69
Stephen P. Teale Data Center	72
Transportation, Department of	85
<u>Education</u>	
California Community Colleges, Chancellor's Office	93
California State University	107
California Student Aid Commission	110
Education, State Department of	115
<u>General Government</u>	
Agricultural Labor Relations Board	137
Criminal Justice Planning, Office of	139
Economic Opportunity, Department of	140
Finance, Department of	144
Food and Agriculture, Department of	147
<u>Health and Welfare</u>	
Aging, Department of	151
Alcohol and Drug Programs, Department of	153
Employment Development Department	159

INDEX (Continued)

	<u>Page</u>
<u>Health and Welfare (Continued)</u>	
Health and Welfare Agency Data Center	165
Health Services, Department of	169
Mental Health, Department of	184
Rehabilitation, Department of	189
Social Services, Department of	194
<u>Legislative, Judicial, and Executive</u>	
Emergency Services, Office of	225
Equalization, Board of	228
Justice, Department of	232
State Controller's Office	234
<u>Resources</u>	
Forestry and Fire Protection, Department of	239
Parks and Recreation, Department of	244
Water Resources, Department of	247
<u>State and Consumer Services</u>	
Franchise Tax Board	253
General Services, Department of	264
State Personnel Board	280

INDEX (Continued)

	<u>Page</u>
<u>Youth and Adult Correctional</u>	
Corrections, Board of	287
Corrections, Department of	288
California State Prison at Folsom	290
Mule Creek State Prison	292
Youth Authority, Department of the	296

DEFICIENCIES COMMON TO VARIOUS AGENCIES

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. Additionally, not all internal audit units that we reviewed fully complied with professional standards. Finally, 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 that 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 182 contracts, we found 97 contracts that did not fully comply with provisions of the California Public Contract Code. For example, 48 contracts were not approved before the beginning of the contract

work. As a result, the State may be liable for contracts that are not in the State's best interests. Additionally, state agencies did not review contractor evaluation forms on file with the Department of General Services or, if the contractor has not had a contract with the State previously, did not include in the contract file a resume of the contractor's major personnel before approving 17 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 8 contracts lacked other documentation. Failure to review or prepare contractor evaluations may cause the State to enter into contracts with unreliable vendors. Finally, 26 contracts failed to comply with other provisions of the California Public Contract Code. Table 2, page 56, provides details of the deficiencies in administering state contracts at various agencies for fiscal year 1988-89.

Sections 10295, 10335, 10360, and 10364 of the California 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, formerly Section 1204, emphasizes the need for contract approval before the beginning of the contract work. Section 10371 of the California Public Contract Code requires each state agency, when contracting for consultant services, to review a contractor evaluation form on file with the Department of General Services or, if the contractor has not had a contract with any state agency previously, to include a resume of the contract participants in the contract file. In

addition, Sections 10347(a) and 10369 of the California Public Contract Code require each state agency to conduct, within 30 days of completing a contract, an evaluation of each contract awarded. Sections 10300 through 10334 and Section 10371 of the California 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 1988-89

Agency	Number of Contracts Reviewed	Number of Contracts Reviewed With at Least One Exception	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	4	3	0	0	0	5
California Exposition and State Fair	10	9	4	0	7	6	1
Corrections, Department of	10	2	0	0	2	0	0
Education, State Department of	12	6	1	5	2	0	0
Employment Development Department	10	5	2	0	3	0	0
Equalization, Board of	10	7	4	0	0	0	4
Franchise Tax Board	10	2	1	0	1	0	0
General Services, Department of	20	5	0	0	2	2	8
Health Services, Department of	10	9	6	4	2	0	0
Mental Health, Department of	10	7	4	0	6	0	0
Motor Vehicles, Department of	10	7	4	1	5	0	2
Social Services, Department of	10	6	5	2	1	0	0
State Controller's Office	10	0	0	0	0	0	0
State Treasurer's Office	10	8	8	0	0	0	0
Transportation, Department of	10	2	2	0	0	0	0
Water Resources, Department of	10	9	0	3	7	0	5
Youth Authority, Department of the	<u>10</u>	<u>9</u>	<u>4</u>	<u>2</u>	<u>8</u>	<u>0</u>	<u>1</u>
Total	<u>182</u>	<u>97</u>	<u>48</u>	<u>17</u>	<u>46</u>	<u>8</u>	<u>26</u>

VARIANCES FROM INTERNAL AUDIT STANDARDS

Six of the 13 internal audit units that we reviewed did not fully comply with the Standards for the Professional Practice of Internal Auditing of the Institute of Internal Auditors, Inc. The California Government Code, Section 1236, requires internal audit units of state agencies to comply with these professional standards, which pertain to independence, management of the internal auditing department, performance of audit work, professional proficiency, and scope of work.

We reviewed the internal audit units of 13 state agencies for compliance with professional standards. For 6 of the agencies, we limited the scope of our review to the internal audit work that they performed and the degree to which the internal audit units were independent of the activities that they audited. In addition, for the remaining 7 agencies, we conducted full-scope reviews to determine whether these agencies were in compliance with all professional standards. The variances from compliance with professional standards are described in the following paragraphs and summarized on Table 3, page 61.

Internal audit units are a basic component of internal control. These units provide management with recommendations to remedy internal control weaknesses, thus, increasing the overall efficiency of

the agencies' operations. In addition, internal audit units may assist external auditors in performing audit work, thus, reducing the State's cost for audits.

Unless internal audit units comply with professional standards, management cannot be certain that the work of the internal auditors is reliable. In addition, external auditors may be precluded from using the work of internal auditors when the internal auditors do not comply with professional standards.

Independence Standard

Four of the 13 internal audit units that we reviewed were not organizationally independent of the activities they audit. The organizational placement of the internal audit units of the Department of Food and Agriculture, the Department of Justice, the Department of Parks and Recreation, and the Department of Rehabilitation impairs the units' independence. If the units are not independent of the areas that they audit, less assurance exists that the audits are conducted in an impartial and unbiased manner. In addition, the charter of the internal audit unit of the Department of Parks and Recreation does not completely describe the unit's position within the department. Without this description, misunderstandings between the auditees and the internal auditors can result.

Standards for Management of the Internal Auditing Department

We reported three weaknesses in compliance with the standard relating to management of the internal auditing department. Two of the weaknesses that we noted were that the Department of Finance and the Department of Parks and Recreation have insufficient quality control procedures. For example, at the Department of Parks and Recreation, we found that the internal audit unit did not prepare work schedules indicating the activities to be audited; progress reports showing budgeted and actual hours and time variances of the activities being audited; or activity reports highlighting significant findings or issues of the activities audited. Failure to plan and manage the audit properly through work schedules and progress reports can result in inefficient use of audit resources.

Standard for Performance of Audit Work

We reported two weaknesses in compliance with the standard relating to performance of audit work. The internal audit unit of the Office of Criminal Justice Planning and the Department of Finance does not always issue the results of its reviews promptly. For example, the internal audit unit of the Office of Criminal Justice Planning completed two reviews in June and August of 1988, but the unit had not issued reports as of June 1989. Because the unit did not issue the reports promptly, the auditees may not be aware of the problems

existing in their programs and, therefore, cannot promptly implement the unit's recommendations.

TABLE 3
 SUMMARY OF VARIANCES FROM PROFESSIONAL STANDARDS
 FOR INTERNAL AUDITORS
 DISTRIBUTION BY STATE AGENCY
FISCAL YEAR 1988-89

<u>Agency</u>	<u>Page Number</u>	<u>Independence</u>	<u>Professional Proficiency</u>	<u>Scope of Work</u>	<u>Performance of Audit Work</u>	<u>Management of Internal Auditing Department</u>
<u>Full-Scope Reviews</u>						
Criminal Justice Planning, Office of	139				1	
Finance, Department of	144				1	2,3
Food and Agriculture, Department of	147	1				
Justice, Department of	232	1				
Motor Vehicles, Department of						
Parks and Recreation, Department of	244	1,2				3
Rehabilitation, Department of	189	4				
<u>Limited-Scope Reviews*</u>						
California Student Aid Commission						
Education, State Department of						
Employment Development Department						
General Services, Department of						
Health Services, Department of						
State Controller's Office**						

* We conducted limited-scope reviews only for the "Independence" standard.

** This limited-scope review included a follow-up on the prior year's finding regarding the "Scope of Work" standard.

SALARY WARRANTS MORE THAN 90-DAYS
OLD ARE NOT PROMPTLY RETURNED
TO THE STATE CONTROLLER'S OFFICE

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 61 locations and found that 16 locations did not return a total of 172 salary warrants to the State Controller's Office within 90 days of receipt. These warrants ranged in amount from \$31.58 to \$3,938.60. The oldest warrant found was dated July 3, 1985, and amounted to \$462.05. Failure to return the undelivered warrants to the State Controller's Office increases the risk of their loss or misappropriation. Table 4 on the following page 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 4

SALARY WARRANTS NOT RETURNED WITHIN 90 DAYS

<u>Agency</u>	<u>Number of Warrants More Than 90-Days Old</u>
California State University (Three campuses)	117
Corrections, Department of (Eight institutions)	10
Developmental Services, Department of (One hospital)	14
Fish and Game, Department of	2
Food and Agriculture, Department of	1
Health Services, Department of	3
Motor Vehicles, Department of	9
State Controller's Office	4
Water Resources, Department of	6
Youth Authority, Department of the (Northern Reception Center and one institution)	<u>6</u>
Total	<u>172</u>

MANAGEMENT LETTERS
BY AREA OF GOVERNMENT

BUSINESS, TRANSPORTATION AND HOUSING

DEPARTMENT OF COMMERCE

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

Item 1. Insufficient Accounting Records for Reimbursement Transactions

Finding: The department did not have records supporting many transactions that it recorded in the reimbursement account. For fiscal year 1987-88, the department could not provide evidence supporting approximately \$179,000 of debit entries and approximately \$132,000 of credit entries in the reimbursement account. The total account balance was stated at approximately \$203,000. As a result of the insufficient support, the department has no assurance that the reimbursement account was stated correctly.

Criteria: The California Government Code, Section 13403(3), requires agencies to have a system of authorization and recordkeeping procedures sufficient to provide effective accounting control over assets, liabilities, revenues, and expenditures.

Recommendation: The department should maintain sufficient accounting records to support all transactions within its reimbursement account.

Item 2. Insufficient Checking Account and Revolving Fund Reconciliation Procedures

Finding: The department did not properly and promptly prepare its reconciliations of the general checking account. Specifically, it did not correctly show monthly activity for receipts and disbursements of individual funds, and it did not sufficiently support unusual reconciling items between the records of the State Controller's Office and the department. Further, for seven months during fiscal year 1987-88, the department prepared the reconciliations from one to seven months late. In addition, for the reconciliations of its revolving fund, the department did not always document the date of preparation and supervisory review. Improper and late checking account and insufficient revolving fund reconciliation procedures may delay detection of cash shortages, errors, or intentional distortion of records.

Criteria: The State Administrative Manual, Section 8060, requires checking accounts to be reconciled promptly at the end of each month. In addition, Section 7967 illustrates the proper form for reconciling the general checking account, which includes separate columns showing receipts and disbursements by individual funds. Finally, Section 7908 requires reconciliations to show the names of the preparer and reviewer and the date of preparation and review.

Recommendation: The department should reconcile its general checking account and revolving fund properly and promptly after the end of each month. In addition, each reconciliation should be dated and signed by the preparer and reviewer.

Item 3. **Inaccurate Identification of Encumbrances**

Finding: The department did not accurately analyze its listing of payables to determine which items represented 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 the failure to analyze the listing of payables accurately as of June 30, 1988, the department incorrectly reported encumbrances at approximately \$4 million to the State Controller's Office. However, we determined that the appropriate encumbrance amount was approximately \$3 million. If the department does not properly identify encumbrances in its financial reports, the State Controller's Office does not have sufficient 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 payables to determine which are valid encumbrances as of June 30. Further, the State Controller's Office issued a memorandum, dated May 20, 1988, instructing agencies 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: During year-end closing, the department should analyze all of its unliquidated encumbrances to determine whether goods were received or services were provided before or after June 30. The

department should correctly report encumbrances on the Report of Accruals to Controller's Accounts.

Item 4. **Insufficient Controls Over Processing of Invoices**

Finding: The department's files do not provide documentation that the department sufficiently controlled its processing of invoices before submitting them to the State Controller's Office for payment. Of the 30 invoices that we tested, 5 contained a total of eight deviations from state procedures. Three invoices lacked evidence that the goods or services had been received, and 5 invoices lacked evidence that the invoices were reviewed. A lack of sufficient controls over processing invoices may result in the improper payment of invoices.

Criteria: The State Administrative Manual, Section 8422.1, requires that all invoices submitted to the State Controller's Office for payment be reviewed for propriety of submission and be supported by adequate evidence that goods or services were received.

Recommendation: The department should include evidence that invoices were reviewed and that goods and services were received before submitting the invoices to the State Controller's Office.

Item 5. **Weakness in Control Over Warrant Disbursements**

Finding: In fiscal year 1987-88, the department issued seven out of eight warrants over \$15,000 with only one signature, when two signatures were required. A lack of sufficient controls over warrants with large amounts may result in proportionately large losses of state funds.

Criteria: The State Administrative Manual, Section 8041, requires the department to obtain two signatures on all warrants over \$15,000, except warrants payable to another state agency.

Recommendation: The department should require two signatures on all warrants over \$15,000, except warrants payable to another state agency.

STEPHEN P. TEALE DATA CENTER

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

Item 1. Possible Liability to the Federal Government

Finding:

The State has a possible liability to the federal government of up to \$4.2 million for the federal share of profits earned by the data center from July 1, 1984, through June 30, 1989. However, the possible liability may be reduced to \$3 million if new federal regulations are adopted. In addition, the State may also owe the federal government for unallowed interest costs incurred by the data center for equipment acquisitions. These charges for unallowed interest charges totaled approximately \$200,000 during fiscal year 1987-88 and approximately \$250,000 during fiscal year 1988-89.

The data center's revolving fund is an internal service fund that provides data processing, equipment acquisitions, and related services to state agencies. The data center charges these agencies more than its costs for services provided. In turn, state agencies have passed on the charges to federal programs. When the data center's charges exceed its costs, the data center's revolving fund accumulates profits. The California Government Code allows the data center to accumulate profits in its revolving fund up to certain limits. However, federal regulations prohibit the State from charging federal programs for more than its costs.

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, approximately \$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, 1989, the data center's accumulated profits have increased by approximately \$28 million, after audit adjustments. The State may be liable to repay the federal government for 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 \$4.2 million. This is the federal share of profits accumulated by the data center during the period July 1, 1984, through June 30, 1989. However, proposed changes to federal regulations may reduce the State's liability to the federal government to approximately \$3 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 and 1988-89. We concluded that the State may have an additional liability to the federal government, under current regulations, of approximately \$450,000 for the federal share of interest costs for equipment acquisitions incurred by the data center during these two fiscal years. For fiscal years 1985 through 1987, 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.

Since 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 data center charges for the period July 1, 1984, through June 30, 1989, charged to federal programs. For the purposes of estimating the possible liability to the federal government, we used the percentage of accumulated profits at June 30, 1984, that was refunded to the federal government. This percentage was 14.8 percent.

The possible liabilities to the federal government exist primarily because the data center's billing system is not designed to recover only the 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 observed a similar weakness during our audit of the data center for fiscal year 1985-86. We recommended that the data center request the Department of Finance to provide the data center special instructions for establishing rates charged to state agencies using the data center. These rates should include the full accrual basis of accounting, including capitalization of equipment and allowance for depreciation. In its response of January 30, 1987, the data center stated, in part, that it had discussed this subject with the Department of Finance on numerous occasions because of its implications for budgetary, funding, and rate-setting requirements. Based upon these meetings, it was mutually agreed that the data center practices were most appropriate.

During our audit for fiscal years 1987-88 and 1988-89, we noted that the Department of Finance did not ensure that the data center or state agencies that receive services from the data center exclude interest costs and amounts that exceed costs when charging federal programs.

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, currently prohibits the State from charging federal programs for amounts that exceed costs. In addition, the Circular A-87 prohibits states from charging federal programs for interest costs for equipment acquisitions.

In October 1988, the federal Office of Management and Budget proposed amendments to Circular A-87. These proposed amendments would allow the State to retain a reasonable working capital reserve in internal service funds of up to 60 days' cash expenditures, excluding the costs for capital items. If the proposed amendments are approved and applied retroactively, the State's liability to the federal government for accumulated profits of the

data center may be reduced to approximately \$3 million. In addition, the proposed amendments would make interest costs on equipment acquisitions on or after January 1, 1989, an allowable cost. As of January 16, 1990, the Office of Management and Budget had not approved the proposed amendments to Circular A-87.

Recommendation: The Department of Finance should ensure that the State complies with federal and state regulations. This could be done by developing guidelines for the data center and state agencies that receive services from the data center. In addition, the Department of Finance should monitor the proposed amendments to Circular A-87 to determine the effects the revisions may have on state charges to federal programs.

Item 2. Charges Not Based on Service Rate Schedule

Finding: During two fiscal years, 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. In fiscal year 1987-88, the data center charged the DMV \$5.2 million, approximately \$2.6 million less than the data center's costs based on its service rate schedule. Furthermore, in fiscal year 1988-89, the data center charged the DMV \$9.76 million, approximately \$4.8 million less than its costs based on its service rate schedule. For fiscal years 1987-88 and 1988-89, the data center charged the DMV about one-third less than its costs based on its service rate schedule.

The acting director of the data center has advised us that the data center agreed to provide services to the DMV based on a fixed-price agreement during a five-year conversion period from fiscal year 1986-87 through fiscal year 1990-91. According to the acting director, the fixed-price agreement applies only to certain processing functions that were being converted to the data center's system. These processing functions contained too many unknown elements to allow the data center and the DMV to accurately determine costs based on the traditional rate method for estimating costs. The acting director advised us that, therefore, in the best interest of the DMV and the existing clients of the data center and with concurrence by the Department of Finance and the Office of the Legislative Analyst, DMV and the data center agreed to the

fixed-price schedule. Thus, the data center, irrespective of written contracts, verbally agreed to provide services to the DMV for fixed amounts instead of charging for actual workload at the published rates.

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. In addition, the charges are inequitable because a disproportionate 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. Although state agencies administer programs financed by various state and federal funds, nearly all of the programs that the DMV administers are financed by state special funds. Because the data center charges the DMV less than it charges other state agencies, the DMV passed on lower charges to programs financed by state special funds than other agencies passed on to programs financed by the various other state funds. Moreover, state agencies that administer federally funded programs passed on the higher charges to federal programs.

Criteria: The State Administrative Manual, Section 8752, referenced in the fiscal year 1987-88 and the fiscal year 1988-89 contracts between the data center and the DMV, specifies that state policy is for departments to recover full costs. Both the 1987-88 and the 1988-89 contracts specify dollar amounts; however, Section 5 of each contract provides that if the amount authorized by the contract is exceeded, the DMV is responsible for all charges incurred and shall amend the agreement to provide the necessary additional funds. The State Administrative Manual, Section 4981.2, requires the State's data centers to charge their users for units of service based upon a published service rate schedule.

Recommendation: The data center should consistently charge its users for service based upon its published service rate schedule.

Item 3. Weaknesses in Controls Over Equipment

Finding: The data center has weaknesses in its control over equipment. Specifically, we noted the following:

- The data center did not reconcile the results of the fiscal year 1987-88 physical inventory of equipment located in the Sacramento area with its general ledger equipment account balance. In our financial audit for fiscal year 1985-86, we reported that the data center had not taken a physical inventory of its equipment for five years. In January 1987, the data center responded that it would perform a physical inventory within a year. The data center performed a physical inventory of equipment located in the Sacramento area during fiscal year 1987-88. However, the data center did not reconcile the results of the physical count with the accounting records. Furthermore, the data center has not conducted a physical inventory of equipment located outside the Sacramento area;
- The data center does not maintain a comprehensive inventory listing of equipment that it has retired from use and stored in its warehouse. In addition, the data center does not prepare a "Transfer of Location of Equipment" document as required by state regulations when equipment is placed in the warehouse. As a result, we could not determine if the data center is properly accounting for equipment that it has retired from use;
- 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 after acquisition when practical. In fiscal year 1987-88, the data center did not attach tags with state identification numbers to 33 of the 45 equipment acquisitions that we tested. In addition, in fiscal year 1988-89, the data center had not attached tags with state identification numbers to any of the 15 equipment acquisitions that we tested. We reported a similar weakness during our financial audit for fiscal year 1985-86. In January 1987, the data center responded that it would tag all equipment upon receipt. During the physical inventory that the data center conducted in fiscal year 1987-88, it attempted to tag all untagged equipment. However, the new tags did not correspond with the identification numbers previously assigned when

the equipment was purchased. The data center often assigns a state identification number to new equipment but does not always attach the identification number tag to the equipment;

- The data center did not prepare property survey reports for any of the 17 equipment dispositions that we tested for fiscal year 1987-88 and for 4 of the 6 equipment dispositions we tested for fiscal year 1988-89; and
- During fiscal years 1987-88 and 1988-89, the data center did not reconcile its detail property records with the equipment schedule that supports the general ledger equipment account balance. We reported a similar weakness during our financial audit for fiscal year 1985-86. The data center responded that it would comply with state requirements. However, the data center has not prepared this reconciliation for fiscal years 1987-88 or 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. Also, 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 Reutilization at the Department of General Services for approval. Furthermore, the State Administrative Manual, Section 8640, requires agencies to prepare a Transfer of Location of Equipment when agencies transfer equipment to another state agency. 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.

Item 4. Weaknesses in Accounting for Equipment

Finding: The data center has weaknesses in its accounting for equipment. Weaknesses in accounting for equipment resulted in incorrect account balances at year end. Specifically, we noted the following:

- The data center does not always prepare stock-received reports promptly when it receives equipment. For example, one of the data center's units received a major item of equipment valued at approximately \$2 million in June 1988 and did not prepare a stock-received report until December 28, 1988. In another instance, a unit received a major item of equipment valued at approximately \$4 million in May 1989 and had not completed a stock-received report as of December 11, 1989. Failure to notify the accounting office of the receipt of equipment at year end results in the data center's incorrectly stating account balances in its financial statements. The data center understated its equipment account balance and its liability for installment purchase contracts by approximately \$2 million at June 30, 1988, because the receiving unit did not prepare a stock-received report when it received a major item of equipment. In addition, the data center understated its equipment account balance and its liability for installment purchase contracts by approximately \$4 million at June 30, 1989;
- The data center did not remove from its equipment balance at June 30, 1988, 4 items of equipment valued at approximately \$3.8 million that it sold or removed from service before the end of the fiscal year. In addition, it did not remove from its equipment balance at June 30, 1989, 9 items of equipment valued at approximately \$1.3 million that it sold or removed from service before the end of the fiscal year. As a result, the equipment balances for both fiscal years were overstated by these amounts. We also noted that an additional 19 equipment items that were

exchanged for new equipment were still recorded in the equipment account as of June 30, 1989;

- The data center did not record in the equipment account three items of equipment that we identified as belonging to the data center. Therefore, the equipment account is incomplete, and the year-end balance at June 30, 1989, was understated;
- The data center did not properly record the purchase of new equipment when it exchanged old equipment for the new equipment. For 2 of the 15 items we tested for fiscal year 1988-89, the data center reduced the cost of the new equipment by the trade-in value of the old equipment. The data center should have recorded the purchase cost of the replacement property without subtracting the value of trade-in equipment. The total trade-in value for the 2 items tested was \$737,000. The equipment account was understated by this amount as of June 30, 1989;
- The data center improperly recorded approximately \$328,000 in the equipment balance at June 30, 1989, because the data center incorrectly identified the payments on installment contracts as equipment purchases. As a result, the data center's equipment balance and its installment contracts payable balance were overstated by \$328,000 at June 30, 1989. The data center should have reduced the installment contracts payable balance at year end by the amount of the payments; and
- The data center does not determine if equipment retired from use is carried at amounts that exceed net realizable value. Therefore, the equipment account's year-end balance may be overstated.

Criteria:

The State Administrative Manual, Section 8410, requires agencies to prepare stock-received reports at the time goods are received and to submit the reports to the appropriate offices within the agencies. In addition, the State Administrative Manual, Section 8642, provides that replacement property will be recorded at the purchase cost paid without subtracting the value of trade-in equipment. Finally, the California Government Code,

Sections 13401 and 13403, requires agencies to maintain a system of internal controls so that they produce accurate and reliable financial data.

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

Item 5. Weaknesses in Depreciation Policies and Procedures

Finding: The data center has weaknesses in its depreciation policies and procedures over equipment. Weaknesses in depreciation policies and procedures may result in the data center's not properly matching revenues earned from the use of the equipment with the costs of the equipment systematically allocated and expensed over the equipment's estimated useful life. The improper matching of revenues with expenses results in an inaccurate presentation of the data center's financial condition and results of operation. Specifically, we noted the following:

- For 30 of the 45 equipment acquisitions that we tested for fiscal years 1986-87 and 1987-88, the data center did not record all costs associated with the acquisitions. It did not record approximately \$57,000 in freight, cabling, and acceptance surcharge costs incurred in placing the equipment in operation. Instead, the data center recorded approximately \$30,000 as expenses and did not record approximately \$27,000 in acceptance surcharge costs because the vendor had not yet billed the data center. In addition, we noted that for 5 of the 15 items we tested for fiscal year 1988-89, the data center did not record in the equipment account approximately \$17,000 in testing, installation, and freight costs incurred in placing the equipment in operation. Instead, the data center recorded these costs as expenses. If the data center does not record in the equipment account all costs necessary to prepare equipment for use, acquisition costs will not be properly allocated over the useful life of the equipment; and
- The data center did not estimate for its equipment a residual value at the end of the equipment's useful life. For example, the data

center sold 9 items of equipment that it had fully depreciated for approximately \$30,000 during fiscal years 1986-87 and 1987-88. We also identified 19 fully depreciated items during fiscal year 1988-89 for which the vendor had given a trade-in value when the items were exchanged for new equipment. Because the data center had not estimated a residual value for the equipment, it recorded as revenue the proceeds that it received from the sale of the equipment. However, the data center had no expenses to match with the revenues it received from the sale of the equipment. State procedures require agencies to depreciate the cost of equipment, less its estimated residual value, over the equipment's estimated useful life.

Criteria: The State Administrative Manual, Section 8614, states that the costs of equipment should include all costs necessary to acquire, install, and prepare equipment for its intended use. In addition, 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 less its estimated residual value to expense over the time periods benefited.

Recommendation: The data center should record in the equipment account all costs necessary to acquire, install, and prepare the equipment for its intended use. In addition, the data center should estimate a residual value for its equipment at the end the equipment's estimated useful life.

Item 6. 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. As of June 30, 1989, the data center had not recorded intangible assets of

approximately \$3.3 million. In addition, the data center overstated its operating expenses for fiscal year 1988-89 by approximately \$600,000. The \$600,000 is the difference between the purchase cost of the software charged directly to operating expense and the accumulated costs of the software systematically charged over five years.

Criteria: The State Administrative Manual, Section 8615.1, requires state agencies to record as intangible assets the costs of intangible assets that have an expected life of at least four years and cost 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 by agencies of the cost of software less its estimate residual value to expense over the periods that the agencies expect to use the software to generate revenues.

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.

Item 7. 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 1987-88, we noted that, for 36 of the 40 deposits we reviewed totaling approximately \$30 million, the data center did not notify the State Controller's Office on time. In addition, for fiscal year 1988-89, we noted that, for 21 of the 25 deposits we reviewed totaling approximately \$44 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 investment or 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. During fiscal year 1987-88, 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 \$153,000 in interest income that the data center's revolving fund should have earned. In addition, during fiscal year 1988-89, we estimate that the State's General Fund earned approximately \$174,000 in interest income that the data center's revolving fund should have earned.

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 the revolving fund.

Item 8. Weakness in the Separation of Accounting Duties

Finding: The data center does not separate its duties over cash transactions to comply with the State Administrative Manual. The person who authorizes disbursements also maintains the general ledger and prepares the bank reconciliations. Failure to adequately separate accounting duties may result in errors or improper cash transactions going undetected.

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.

DEPARTMENT OF TRANSPORTATION

We reviewed the financial operations and 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.

Item 1. Revolving Fund Not Reconciled Promptly

Finding: The department does not reconcile its revolving fund promptly. Although the department has corrected some of the weaknesses that we reported in previous years, we noted the following specific deficiencies in fiscal year 1988-89.

- The department frequently does not promptly reconcile the cash balance of its revolving fund with the cash balance recorded by the State Controller's Office. The department completed 11 of the 12 monthly reconciliations for fiscal year 1988-89 more than 30 days after the end of the applicable month. The department completed the 12 reconciliations an average of 76 days after the end of the applicable month. We reported a similar weakness in our audit for fiscal year 1987-88.

- In January 1989, the department had a \$1.2 million unreconciled difference between the cash balance of its revolving fund and the cash balance recorded by the State Controller's Office. However, these balances were reconciled in June 1989.

Failure to reconcile the revolving fund promptly can delay the detection of errors or irregularities in the department's records or records of the State Controller's Office.

Criteria: The State Administrative Manual, Section 8060, requires the department to reconcile its bank accounts with its records at the end of each month. Further, Section 7900 requires that the reconciliations be prepared monthly within 30 days after the end of the preceding month.

Recommendation: The department should reconcile the revolving fund promptly each month.

Item 2.

Federal Reimbursement Not Billed Promptly

Finding:

The department did not promptly bill the federal government for the federal government's share of certain costs for a utility relocation project. For one of eight transactions that we reviewed, the department did not promptly bill the federal government for \$353,000 in project costs. The department should have billed the federal government in November 1988, when the department completed its audit of the project costs. However, the department did not bill the federal government until June 1989.

The department loses interest earnings when it does not promptly bill the federal government. We estimate that the department lost approximately \$19,000 in interest because it did not promptly bill the \$353,000 in costs for the utility relocation project.

Criteria:

The State Administrative Manual, Section 0911.4, requires state agencies to bill the federal government promptly.

Recommendation:

The department should promptly bill the federal government for the federal share of eligible project costs.

Item 3.

Reports of Expenditures Not Submitted Promptly

Finding:

The department's Los Angeles district office did not submit either preliminary or final reports of expenditures for completed construction projects to the department headquarters by the required deadlines. As of June 30, 1989, the department identified 22 Los Angeles district projects for which the district office had not prepared preliminary or final reports of expenditures within 120 days of completion of the project as required by the Caltrans Accounting Manual. As of July 18, 1989, the district office had completed final reports of expenditures for 12 of the 22 projects. However, the district office completed reports for the 12 projects between 53 and 480 days after the required deadlines.

The department cannot submit final claims to the Federal Highway Administration (FHWA) for project costs until the district office submits the preliminary or final reports of expenditures. Furthermore, until the FHWA reviews and approves a

preliminary or final claim, the department cannot reallocate the unused portion of authorized funds from the completed project for use on other projects. For the 22 projects noted above, the unused portion of authorized funds totaled approximately \$3.8 million at June 30, 1989.

The accounting administrator of the Los Angeles district office said the office cannot always meet the submission deadline because it does not always receive final progress payment vouchers from the district's construction and maintenance units within the 120-day period.

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

Recommendation: The department's district offices should obtain the necessary information to complete the preliminary or final reports of expenditures within 120 days of a project's completion.

Item 4. Accounting System and Billing Systems Not Completely Reconciled

Finding: The department has not completely reconciled its accounting and billing systems as of June 30, 1989. However, the department reduced the unreconciled difference from \$40 million on June 30, 1988, to \$379,000 on June 30, 1989.

The department records expenditures in its accounting system, differentiating costs that are eligible for federal reimbursement from those that are not eligible. It records in its current billing system only the project costs that are eligible for federal reimbursement. The department uses its current billing system to bill the federal government for the federal share of the project costs. However, the department had been unable to reconcile totals for costs that are eligible for federal reimbursement in the two sets of records because the current billing system does not contain the same records of appropriation and project detail that the accounting system contains.

We reported a similar weakness in our audits for fiscal years 1986-87 and 1987-88. In its response to our management letter for fiscal year 1987-88, the department stated that this weakness would be resolved when a new system, Current Billing and Reporting System (CBARS), was implemented in July 1989. We will review the reconciliations of the accounting and billing systems during our financial and compliance audit for fiscal year 1989-90.

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

Recommendation: The department should perform regular reconciliations of its accounting and billing systems.

Item 5. Noncompliance With Certain Federal Requirements

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

- For one of five purchases of construction materials that we reviewed at the San Francisco district office, the office did not inspect the accumulated materials before claiming federal funds. When the contract provisions provide for accumulating construction materials, the Code of Federal Regulations, Title 23, Section 635.114, requires the department to inspect materials in order to claim federal funds.
- For one of ten purchases of construction materials that we reviewed at the Los Angeles district office, the office paid more than the contract price for the accumulated materials. When the contract provisions provide for accumulating construction materials, the Code of Federal Regulations, Title 23, Section 635.114, requires that the department claim federal funds for no more than the contract amount for construction materials.

- For 15 of 22 completed construction and local assistance project files we reviewed at the department, the department did not promptly submit final claims to the Federal Highway Administration (FHWA). The Federal-Aid Highway Program Manual, Volume 1, Chapter 4, Section 6, requires the department to submit final claims for federal aid promptly. In addition, the department and the FHWA have agreed that the department should submit final claims for projects within 24 months of completion of the project.
- The department did not obtain FHWA approval for certain major changes to a federally reimbursable construction contract. For one of 22 contracts that we reviewed, the department did not obtain FHWA approval for an increase in contract costs of \$84,071. The Code of Federal Regulations, Title 23, Section 635.121, requires the department to obtain FHWA approval for major contract changes.

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

Item 6. **Weakness in Separation of Duties Over Cash Collections**

Finding: The department's Orange County district office does not properly separate duties related to cash collections. Specifically, one employee receives rental collections and also records the receipts in the accounting records. Without proper separation of duties, errors or irregularities may go undetected, and management may be unable to place responsibility for the errors or irregularities.

Criteria: The State Administrative Manual, Section 8080, specifies that individuals responsible for receiving and depositing cash collections must not record the collection in any subsidiary ledger affected by cash collections.

Recommendation: The Orange County district office should reassign duties among employees in the accounting office to provide proper separation of duties. If necessary, the district office should use employees of units other than the accounting unit to provide proper separation of duties.

Item 7.

Errors in Recording Federal Transactions

Finding:

The department's district offices made several errors in its accounting records concerning eligibility for payments for federal reimbursement. The department's Audits and Internal Security (AIS) unit noted the following specific errors.

- The San Diego district office incorrectly recorded as eligible for federal reimbursement three ineligible payments totaling approximately \$2,900. The AIS unit determined that the district office corrected the errors, caused by keypunch mistakes, after the AIS unit brought the errors to the district office's attention.
- The Marysville district office incorrectly recorded as eligible for federal reimbursement \$1,399 for the lease of a resident engineer's office space. The district subsequently corrected the error. As a result, the federal government may reimburse the department for more than the federal government's share of costs.

Criteria:

The Code of Federal Regulations, Title 23, Part 140, describes billing procedures and reimbursable costs. In addition, the department's Coding Manual, Volume I, Chapter 5, describes the correct method of recording eligibility of payments for federal reimbursement. Further, the department's accounting memo, A-87-23, describes the correct method of recording lease payments for a resident engineer's office space.

Recommendation:

The department should ensure that its district offices record the correct federal eligibility codes into the department's automated accounting system.

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 Health and Human Services grant, Federal Catalog Number 13.786, and the U.S. Department of Education grant, Federal Catalog Number 84.048.

Item 1. Improper Control Over Cash Management

Finding:

The Chancellor's Office did not always properly control the system for managing its federal vocational education funds. The Chancellor's Office acts as an intermediary in the allocation of these funds between the State Department of Education (SDE) and subrecipient organizations, including community college districts. Each fiscal year, the Chancellor's Office contracts with the SDE for the Chancellor's Office's share of the federal vocational education funds. The Chancellor's Office requests cash advances of its federal vocational education funds from the SDE and then disburses the funds to the subrecipients. During our audit, we noted the following conditions:

- The Chancellor's Office did not limit the cash advances to the immediate needs of the subrecipient organizations during the first eight months of fiscal year 1988-89. At the end of July 1988, the Chancellor's Office had approximately \$2.2 million in excess cash advances from its contracts with the SDE. The Chancellor's Office disbursed these excess funds during the first eight months of fiscal year 1988-89; and
- During the last four months of fiscal year 1988-89, the Chancellor's Office did not ensure that it had received the federal vocational education funds from the SDE before making disbursements to the subrecipients. The Chancellor's Office, as of June 30, 1989, paid the subrecipients approximately \$2.9 million in unreimbursed vocational education funds. The Chancellor's Office requested a reimbursement for approximately \$2.6 million from the SDE in June 1989, but it did not receive the reimbursement from the SDE until July 28, 1989.

During the first eight months of fiscal year 1988-89, the federal government lost interest because the Chancellor's Office did not ensure that cash advances of vocational education funds were limited to the subrecipients' immediate needs. In addition, during the last four months of fiscal year 1988-89, the State lost interest because the Chancellor's Office did not ensure that it had received federal funds from the SDE before making disbursements to the subrecipients. Finally, noncompliance with federal cash requirements could result in the termination of advance financing by the federal government. We reported a similar weakness in our audit for fiscal years 1986-87 and 1987-88.

Criteria: The Code of Federal Regulations, Title 31, Section 205.4(a), 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. 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 properly control its system for managing its federal vocational education funds to ensure that federal funds are limited to its and the subrecipients' immediate needs. Furthermore, when appropriate, the Chancellor's Office should ensure that it receives federal money from the SDE before making disbursements to the subrecipients.

Item 2. **Inaccurate and Unsupported Payments for the Vocational Education Program**

Finding: The Chancellor's Office inaccurately calculated payments to two community college districts for the vocational education program. Also, the Chancellor's Office did not have documents to support the allocation it calculated for one community college district in the program.

Specifically, for two of the nine Vocational Education Adult Training allocations that we tested, the Chancellor's Office erred in recording the adult population data for the two community college

districts. The Chancellor's Office uses the data to allocate funds. As a result, one district was overallocated approximately \$18,500, and one district was underallocated approximately \$18,500.

Further, for one of the 11 vocational education allocations for handicapped students that we reviewed, the Chancellor's Office did not have documents from the community college district supporting the enrollment numbers of handicapped students. As a result, the district may have received as much as \$11,400 that it was not entitled to.

Criteria: The Code of Federal Regulations, Title 34, Section 80.20(a), requires that the State account for grant funds in accordance with state laws and procedures for spending and accounting for its own funds. Further, the California Government Code, Section 13403(a)(3), requires a system of internal accounting and administrative control to include authorization and recordkeeping procedures that provide effective accounting control over expenditures. Finally, the Code of Federal Regulations, Title 34, Section 401.95(b), requires that the State allocate 50 percent of the amount reserved for the allocation for handicapped students on the basis of the relative number of such students served during specified enrollment years.

Recommendation: The Chancellor's Office should correct for the error in the amounts allocated to the two community college districts for Vocational Education Adult Training. Also, the Chancellor's Office should retain enrollment data that it uses to determine a district's allocation for handicapped students.

Item 3. Inappropriate Funding Period Charged

Finding: The Chancellor's Office may have charged federal vocational education funds to one funding period that should have been charged to another funding period. Specifically, the Chancellor's Office contracted with community college districts for various periods between August 1985 and December 1987. The Chancellor's Office identified these contracts as Gender Equity Mini Grants under the Vocational Education Act for fiscal year 1985-86. However, it recorded in its accounting records the expenditure of these funds as expenditures for fiscal year 1980-81. The

Chancellor's Office could not provide documentation that would allow us to determine whether it charged the expenditures to the correct federal funding period.

Criteria: The Code of Federal Regulations, Title 34, Section 80.23, requires that the State charge to the grant only costs resulting from obligations of the funding period unless carryover of unobligated balances is permitted, in which case the carryover balances may be charged for costs resulting from obligations of the subsequent funding period.

Recommendation: The Chancellor's Office should charge to the federal vocational education program only costs resulting from obligations of the funding period.

Item 4. Late and Inaccurate Federal Financial Report

Finding: The Chancellor's Office submitted its final financial status report (status report) for its fiscal year 1986-87 vocational education program late. Further, the Chancellor's Office did not prepare an accurate status report, and it did not reconcile the status report with its accounting records until after the State Department of Education (SDE) informed the Chancellor's Office that its amounts differed from the amounts recorded by the SDE's accounting unit. During our audit, we noted the following conditions:

- The Chancellor's Office submitted its corrected fiscal year 1986-87 status report for its vocational education program in November 1989, nearly a year after the due date of December 31, 1988. The Chancellor's Office submits the status report to the SDE, and the SDE submits the report to the federal government. The Chancellor's Office attributed its delay in submitting the status report to insufficient staffing and to the late transmittal of necessary data from the California Community Colleges; and
- The Chancellor's Office did not correctly prepare the fiscal year 1986-87 status report, and it did not reconcile the status report with its accounting records before submitting the status report to the SDE. The Chancellor's Office initially submitted its 1986-87 status report to the SDE in September 1989; however,

the Chancellor's Office amounts differed from the SDE's amounts. As a result, the Chancellor's Office reconciled its status report with its accounting records and with the SDE amounts and then submitted the corrected status report to the SDE in November 1989. Failure to reconcile the status report with the accounting records can cause the SDE to misstate its claims for reimbursement from the federal government. The failure to reconcile may also prevent the early detection of errors or irregularities such as erroneous adjustments and nonreceipt of federal funds.

We reported similar weaknesses during our audit for fiscal year 1987-88.

Criteria: 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. In addition, the State Administrative Manual, Section 20014, requires agencies receiving federal funds to reconcile federal financial reports with the official accounting records and to retain all supporting schedules and worksheets for a minimum of three years.

Recommendation: The Chancellor's Office should ensure that it submits its status report promptly. In addition, the Chancellor's Office should ensure that the status report is accurate and is reconciled with the official accounting records before submitting the status report to the SDE.

Item 5. Incorrect Calculation of Apportionments for Disabled Student Programs and Services

Finding: The Chancellor's Office did not calculate apportionments for Disabled Student Programs and Services for fiscal year 1988-89 in accordance with state statutes. The Chancellor's Office calculated the fiscal year 1988-89 apportionment based upon prior year apportionment calculations plus a 1.8 percent increase based on the percentage increase in the budget for Disabled Student Programs and Services from fiscal year 1987-88 to fiscal year 1988-89. For fiscal year 1988-89, community college districts were entitled to receive up to \$785 per disabled student per fiscal year. The State may apportion more than \$785 per disabled student to

districts that have specific programs or to districts that incurred excess costs for educational services provided to severely disabled students. Of the 71 community college districts, 8 received amounts in excess of the \$785 per disabled student. Furthermore, the Chancellor's Office was unable to provide documentation that the 8 districts incurred excess costs for services for severely disabled students.

In November 1989, the Chancellor's Office drafted proposed amendments to the California Education Code, Section 84850(a), to revise the apportionment calculations for Disabled Student Programs and Services. Specifically, the Chancellor's Office is proposing to eliminate the \$785 per disabled student entitlement, and it is proposing that the community college districts receive amounts based upon the cost of services the districts provided to disabled students.

Criteria: The California Education Code, Section 84850(a), states that the apportionment to community college districts for Disabled Student Programs and Services is not to exceed \$785 per disabled student per fiscal year. The California Education Code, Section 84850(d), states that amounts not to exceed three times the amount authorized in Section 84850(a) may be provided for excess costs of educational services for severely disabled students. These allocations must only go to specified programs.

Recommendation: The Chancellor's Office should follow the California Education Code, Section 84850(a) and (d), when apportioning funds to community college districts for Disabled Student Programs and Services. In addition, the Chancellor's Office should maintain documentation for community college districts that received funds above the statutory limitation for educational services the districts provided for specific programs or to severely disabled students.

Item 6. Deficiencies in Administering State Contracts

Finding: The Chancellor's Office does not obtain approval from the Department of General Services (DGS) for certain types of contracts with community college districts because the Chancellor's Office considers these agreements to be local assistance grants, which are exempt from DGS approval.

We reviewed three kinds of agreements with the community college districts to determine whether they were grants that did not require DGS approval or contracts that did require DGS approval: the first kind was an agreement to provide federal funds to community college districts to provide for vocational education services and would not provide a direct benefit to the State; the second kind was an agreement to provide state funds for matriculation services and would fulfill a statutory duty of the Chancellor's Office and provide a direct benefit to the State; and the third kind consisted of agreements to provide state funds in return for a direct benefit to the State, and these agreements would not fulfill a statutory duty of the Chancellor's Office.

The Legislative Counsel reviewed two of the agreements with community college districts to provide vocational education and matriculation services. According to the Legislative Counsel's interpretation of the Public Contracts Code, Section 10295, and the California Education Code, Section 78211.5, DGS approval is not required for the first kind of agreement to provide vocational education services since the Chancellor's Office is merely acting as a conduit for federal funds and receives no direct benefit as a result of the agreement. Thus, these agreements are grants that do not require DGS approval. However, the Legislative Counsel concluded that the Chancellor's Office should obtain DGS approval for the second kind of agreement to provide matriculation services. The Legislative Counsel concluded that the Chancellor's Office receives a direct benefit in the form of services since the agreement involved state funds and would facilitate the Chancellor's Office carrying out its statutory duty to provide initially for full implementation of matriculation services. Thus, these agreements are contracts that do require DGS approval.

Although the Legislative Counsel did not specifically review the third set of agreements, which included agreements for work such as deferred maintenance and hazardous substance removal, our review of the Legislative Counsel's opinions on similar agreements suggests that these agreements are contracts and also require DGS approval since state funds are being used to provide a direct benefit to the Chancellor's Office. These agreements appear to be contracts offering a direct

benefit to the State because state funds are exchanged for contractual obligations of the community college districts. If the districts do not fulfill their contractual obligations, the contract provides that the Chancellor's Office does not need to pay the community college district. For example, if the community college district fails to perform its contractual obligation, the agreements regarding deferred maintenance and hazardous substance removal permit the State to terminate the agreement and pay the district only the reasonable value of the services provided to date. Based upon two opinions from the Attorney General's Office, the Chancellor's Office considers these agreements to be local assistance grants that do not require DGS approval. However, we reviewed these opinions, which did determine that certain grants did not require DGS approval, but these grants involved the expenditure of federal, not state funds, and so do not require DGS approval. The third kind of agreements we reviewed involved the expenditure of state funds, and so we conclude they are contracts and, therefore, require DGS approval.

If the Chancellor's Office does not obtain DGS approval for those agreements not specifically exempt from such approval, the Chancellor's Office cannot be certain that these agreements are valid contracts and in the State's best interest.

Criteria: The California Public Contracts Code, Section 10295, states that all contracts, unless otherwise exempt, entered into by any state agency for services are void unless and until approved by the DGS. Additionally, the State Administrative Manual, Section 1206, states that all contracts, unless otherwise exempt, are subject to approval by the DGS. Finally, the California Education Code, Section 78211.5, states that the Chancellor's Office is required to provide initially for full implementation of matriculation services that are subsequently provided at community colleges.

Recommendation: The Chancellor's Office should obtain approval from the DGS for contracts such as the contract for matriculation services that involve the expenditure of state funds and provide a direct benefit to the Chancellor's Office by fulfilling one of its statutory duties. Also, the Chancellor's Office should either obtain DGS approval for those contracts that provide a direct benefit to the State in return for state funds even though they may not

of 50 claims transactions, we found a total of 3 transactions lacking evidence that the Chancellor's Office had received the billed goods or services before paying for them. As a result, the Chancellor's Office may have paid for goods or services that it has not received. In addition, the Chancellor's Office does not always ensure that expenditures have proper authorization before payment. Thirteen of the 50 transactions that we reviewed lacked proper authorization. For example, 3 travel claims had no authorizing signatures, and 5 transactions had signatures from unauthorized employees. If proper authorization is not obtained, the Chancellor's Office is not always assured that all of its expenditures are appropriate. We reported similar weaknesses in our audits for fiscal years 1987-88, 1986-87, and 1985-86.

Criteria: The California Government Code, Section 13403(a)(3), describes the elements of a satisfactory system of internal accounting and administrative control, including authorization and recordkeeping procedures that provide effective accounting control over expenditures. In addition, the State Administrative Manual, Section 8422.1, requires each agency to determine that goods and services have been received before payment is made and to determine that invoices comply with the provisions of purchase orders, contracts, leases, service agreements, and similar documents.

Recommendation: The Chancellor's Office should ensure that someone verify the receipt of goods and services before paying for them and that its purchasing procedures comply with state requirements. In addition, the Chancellor's Office should establish a list, including specimen signatures, of those in a position of authority to sign documents.

Item 9. Weaknesses in Control Over the Revolving Fund

Finding: The Chancellor's Office has weaknesses in its control over its revolving fund. We noted the following deficiencies:

- The Chancellor's Office improperly used the revolving fund to pay some vendor invoices. To accommodate two consultants, the Chancellor's Office paid invoices by revolving fund checks rather than through the normal claims processing procedure. Improper use of the

revolving fund circumvents state controls over disbursements and could result in a misuse of state funds;

- The Chancellor's Office did not always obtain authorization before payment of services through the revolving fund. During our review, we noted two revolving fund disbursements, for services, that the Chancellor's Office did not approve before payment. Insufficient control over the revolving fund can result in a misuse of state funds; and

- The Chancellor's Office does not properly maintain its listing of advances made from the revolving fund. During our review of the June 30, 1989, listing, we noted the following: several items were outstanding since fiscal years 1986-87 and 1987-88, at least two items listed were voided payments, and several items had credit balances. Because of insufficient documentation, we were unable to verify the collectibility of the long-outstanding advances. Insufficient controls over revolving fund activities can result in undetected errors and irregularities and unnecessarily reduce funds available for other uses. The accounting administrator concurred that the listing of advances made from the revolving fund at June 30, 1989, was not accurate. The administrator stated that several errors made during the past few years have never been researched and many of the errors cannot be resolved due to lack of support documentation. The accounting administrator stated that lack of accounting staff has prevented the accounting unit from properly maintaining the listing. In fiscal year 1989-90, the accounting administrator plans to implement procedures to properly maintain the listing and to determine the amount of outstanding revolving fund advances that are properly supported and collectible. The administrator will file a Board of Control claim for the uncollectible amount.

Criteria:

The State Administrative Manual, Section 8110, states that the appropriate uses of revolving funds include paying for compensation earned, travel expenses and advances, and immediate payments when necessary. Section 8422.1 requires an agency to determine that authority existed to obtain goods and

services. Section 8116 provides for an agency to reimburse and, therefore, clear advances from the records 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 made from the revolving fund to account for all the fund's transactions.

Recommendation: The Chancellor's Office should use the revolving fund only for authorized purposes. In addition, the Chancellor's Office should ensure that all revolving fund disbursements are authorized before payment. Moreover, the Chancellor's Office should implement procedures to collect on all long-outstanding advances and procedures to properly maintain the listing of advances made from the revolving fund.

Item 10. **Accounting Transactions Insufficiently Documented**

Finding: The Chancellor's Office was unable to identify or document and, therefore, could not resolve four reconciling items, totaling approximately \$53,000, that were included on the June 30, 1989, reconciliation of its general checking account. Two of these items were outstanding for over three years and the remaining two 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 two years. Three of these items were outstanding for over three years.

We reported a similar weakness in our financial audits for fiscal years 1987-88, 1986-87, and 1985-86. The Chancellor's Office concurred with the weakness and stated that it would implement procedures to correct the weakness. However, as of June 30, 1989, 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 and every unusual reconciling item be traced by the person reconciling the bank statement to identify its nature.

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

Item 11. **Weak Internal Controls Over Property**

Finding: As we have reported for the last six years, the Chancellor's Office has not reconciled its physical inventory of property with its accounting records for the last seven years. In addition, the Chancellor's Office has not completed a physical inventory of all property within the last three years. The Chancellor's Office initiated a comparison of the physical inventory completed in February 1985 to the property records existing before a February 1983 fire but did not complete this comparison. The Chancellor's Office plans to initiate a physical inventory of all property in February 1990 and to complete the inventory by June 30, 1990. 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.

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.

Item 12. **Noncompliance With Certain Federal and State Requirements**

Finding: We noted the following instances where the Chancellor's Office did not always comply with administrative requirements of the federal government and State.

- For one of the 25 vocational education special projects that we reviewed, the Chancellor's Office could not locate evidence of receipt of the product that it contracted for;
- For six of the nine Vocational Education Adult Training and Title II, Part B allocations that we reviewed, the Chancellor's Office could not provide support for the community college district's number of unemployed that the Chancellor's Office used to allocate funds;
- For one of the 25 vocational education special projects that we reviewed, the Chancellor's Office overpaid the contractor by \$441 because the Chancellor's Office miscalculated the final payment and did not keep the payment log current; and
- For one of the 25 contracts for vocational education special projects that we reviewed, the Chancellor's Office could not locate the interagency agreement it had with another state agency.

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.

Criteria:

The Code of Federal Regulations, Title 34, Section 80.20(a), requires the State to account for grant funds in accordance with state laws and procedures for spending and accounting for its own funds. Further, the California Government Code, Section 13403(a)(3), requires a system of internal accounting and administrative control to include authorization and recordkeeping procedures that provide effective accounting control over expenditures.

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).

Item 1. Inaccurate Analysis and Reporting of Encumbrances

Finding: CSU Long Beach and CSU Fresno did not accurately analyze and report encumbrances at June 30, 1989. 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 Long Beach and CSU Fresno overstated encumbrances on their memo entries on the Report of Accruals to Controller's Accounts by \$1,178,000 and \$831,000, respectively. These misstatements occurred because CSU Long Beach and CSU Fresno did not thoroughly analyze their commitments to determine whether they had received the goods or services before or after June 30.

In addition, the CSU Controller's Office did not report the correct amount of encumbrances on the memo entries on the Report of Accruals to Controller's Accounts for three capital outlay funds that we reviewed. The CSU Controller's Office had identified the encumbrances correctly on its detail listing but picked up the wrong numbers when transferring the amounts from the detail to the report sent to the State Controller's Office.

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 a similar weakness at other campuses for fiscal year 1987-88.

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 Long Beach and CSU Fresno should 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. The CSU Controller's Office should review the Report of Accruals to Controller's Accounts before submitting it to the State Controller's Office to ensure it has reported the correct amount of encumbrances on its memo entries.

Item 2. Noncompliance With Certain State Requirements

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

- CSU Long Beach did not take advantage of vendor discounts totaling approximately \$4,300 on all 23 invoices we reviewed that offered vendor discounts. The State Administrative Manual, Section 8422.1, requires that agencies determine that cash discounts have been taken before submitting claims to the State Controller's Office for payment.
- CSPU Pomona lacks sufficient separation of duties for employees who process cash disbursements. Specifically, one employee has control over the blank check stock, the two keys that are required to run the signature machine, and the responsibility for mailing checks. The State Administrative Manual, Sections 8080 and 8081, prescribes separation of duties for agencies with manual systems.
- CSPU Pomona did not require two signatures on five of eight checks we examined that were greater than \$15,000 and payable to vendors outside the state system. We also noted one check at CSU Fresno that did not contain two signatures as required. 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, another state agency, or special dispensation is received.

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 California State University campuses should improve their compliance with each of the state requirements.

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.

Item 1. No System To Detect Errors in Federal Reimbursements

Finding: The commission did not have a system to detect errors in federal reimbursements to the commission. The federal government reimburses the commission for its payments to lenders for defaulted student loans. Based on information it receives from the commission, the federal government calculates its reimbursements to the commission, reducing the reimbursement by the federal share of the commission's subsequent collections on defaulted loans.

In August 1988, the federal government erroneously recorded subsequent collections of approximately \$875,000 twice. As a result, the federal government underpaid the commission by approximately \$875,000. Because the commission did not review the federal reimbursement, it did not detect the error. After we detected the error, the federal government paid the commission the \$875,000.

According to the commission's chief of administrative services, the commission's new financial aid processing system, which the commission is implementing during the 1989-90 fiscal year, includes a system to review federal reimbursements.

Criteria: The California Government Code, Section 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 commission should ensure that it effectively reviews each federal reimbursement to determine whether the federal government calculates the amount correctly.

Item 2. **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. For 22 of 48 loans that we reviewed, the service contractor or the assigned collection agencies failed to perform at least one of the required collection procedures. Although the service contractor or all of the collection agencies for these 22 loans made insufficient collection efforts on some loans, one collection agency made insufficient collection efforts on all 9 of its loans that we reviewed. Because collection procedures were not performed as required, the commission 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.

Criteria: The Code of Federal Regulations, Title 34, Section 682.410(b)(4), requires the commission to engage in diligent collection efforts and specifies required collection procedures.

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

Item 3. **Failure To Ensure That Defaulted Student Loans Met Federal Requirements for Reimbursement**

Finding: The commission did not ensure that all of the defaulted student loans that it submitted for reimbursement to the federal government met the federal requirements for reimbursement. During fiscal year 1988-89, the federal government reimbursed the commission for approximately 53,700 defaulted student loans totaling approximately \$135 million. Of the 48 loans that we reviewed, we found that 19, for which the commission was reimbursed \$70,800, did not meet all of the federal requirements for reimbursement. Specifically, for 6 of the loans, the commission did not pay the lender within the required 90 days of the date that the lender filed the claim. Rather, it paid the lenders from 97 to 314 days after the dates the lenders filed the claims. For 11 of the loans, the amount

requested for reinsurance was incorrect. For the remaining 2 loans, the commission both paid the lender late and requested an incorrect amount for reinsurance. For the loans with inaccurate reinsurance amounts, the errors were immaterial and most resulted from one lender's misinterpretation of the commission's instructions and the commission's failure to correct the errors caused by this misinterpretation. Nevertheless, the federal government could require the commission to repay the \$70,800 in funds that it has received for all 19 defaulted student loans.

In January 1989, we reported the commission's noncompliance with the 90-day requirement during fiscal year 1987-88. After we reported the noncompliance, the commission improved its compliance with the 90-day requirement.

Criteria:

The Code of Federal Regulations, Title 34, Section 682.406(a), lists the conditions that a defaulted student loan must meet in order to qualify for federal reimbursement. These conditions include a requirement that the commission pay the lender's claim for the loan within 90 days of the date that the lender filed the claim. In addition, Circular A-102, Attachment G, of the Office of Management and Budget requires that the grantee's financial management system provide accurate, current, and complete disclosure of the financial results of each grant program.

Recommendation:

The commission should pay lenders for defaulted student loans within 90 days of the date that the lenders file claims. In addition, the commission should review requests for reinsurance to ensure their accuracy.

Item 4.

Federal Quarterly Reports Not Reconciled With Accounting Records

Finding:

The commission's federal quarterly report for April through June 1989 contains information that does not reconcile with the commission's accounting records and that may be inaccurate. Specifically, the commission reported in the quarterly report \$90,498 more in lender claims paid and \$30,835 more 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 fiscal years 1985-86, 1986-87, and 1987-88. The commission responded that its internal audit unit and the contract management staff were aware of this problem and were working to correct the matter. Noncompliance with federal reporting requirements could cause the federal government to take action against the commission's administration of the federal Higher Education Act Insured Loans program.

According to the commission's chief of administrative services, the commission's new financial aid processing system, which the commission is implementing during the 1989-90 fiscal year, provides for the reconciliation of the federal reports with the accounting records.

Criteria: Circular A-128 of the Office of Management and Budget requires that federal reports contain information that is supported by the agency's accounting records.

Recommendation: The commission should reconcile the quarterly reports with its accounting records.

Item 5. Ineffective System for Preventing a Collection Agency From Performing Conflicting Services on the Same Loan

Finding: The commission did not have an effective system to prevent a collection agency from contracting to collect on the same student loan for which the agency had performed 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 20 loans that we reviewed, the same collection agency that performed supplemental preclaims assistance also contracted to collect on the loan. As a result, the federal government could refuse to reimburse the commission for the cost of supplemental preclaims assistance.

According to the commission's chief of administrative services, the commission's staff has determined the cause of the problem and has accordingly changed its procedures for assigning loans to collection agencies.

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.

Item 6. **Defaulted Loans Not Reported to National Credit Bureaus**

Finding: The commission did not consistently report reinsured defaulted student loans to national credit bureaus. For 3 of the 12 loans that we reviewed, neither the credit bureaus' nor the commission's records show any indication that the commission notified the credit bureaus of the defaults. As a consequence, a guarantee agency other than the commission could insure additional guaranteed student loans to a borrower with defaulted loans.

According to the commission's chief of administrative services, commission staff is taking steps to ensure that all required defaults are reported in the future.

Criteria: The Code of Federal Regulations, Title 34, Section 682.410(b)(3), requires the commission to promptly report to all national credit bureaus the default date of student loans.

Recommendation: The commission should report all appropriate defaulted student loans to national credit bureaus.

STATE DEPARTMENT OF EDUCATION

We reviewed the financial operations and related internal controls of the State Department of Education (department) and the department's administration of 12 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 Health and Human Services, Federal Catalog Number 13.786; the U.S. Department of Labor grant, Federal Catalog Number 17.250; and the U.S. Department of Education grants, Federal Catalog Numbers 84.010, 84.011, 84.027, 84.048, 84.151, and 84.173.

Item 1. Misstatement of Account Balances

Finding: The department inaccurately calculated and classified certain expenditure and liability accruals for the State Legalization Impact Assistance Fund. Because these expenditures are reimbursed by the federal government, inaccurate calculations result in corresponding inaccuracies in revenue and asset accruals. During our audit, we found the following errors related to accruals of assets, liabilities, revenues, and expenditures:

- The department understated the accrual of assets, liabilities, revenues, and expenditures by approximately \$8.0 million. This understatement occurred primarily because the department reported grant balances owed to subrecipients as of August 24, 1989, instead of June 30, 1989. As a result, three accounts--due from the federal government, revenues, and expenditures--were understated by approximately \$8.0 million, and two accounts--due to other governments and accounts payable--were understated by approximately \$7.8 million and \$167,000, respectively.
- In its financial reports, the department incorrectly classified as accounts payable approximately \$54.3 million of amounts due to other governments and approximately \$900,000 of amounts due to other funds.

Criteria: The California Government Code, Section 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. Also, the State Administrative Manual, Section 7630, requires that only amounts due to private entities for outstanding obligations be reported as accounts payable.

Recommendation: The department should review available financial information to ensure that the amounts it accrues are as accurate as possible. In addition, the department should classify its liabilities in accordance with the State Administrative Manual.

Item 2. Insufficient Controls Over Cash and Cash Receipts

Finding: The department did not maintain sufficient controls over certain areas of cash and cash receipts. 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 25 of 30 receipts received from July 1988 through June 1989 that we reviewed, the department was 3 to at least 70 working days late in notifying the State Treasurer's Office, or an average of 26 working days. 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. According to officials of the department, the late notification was caused by delays inherent in the California State Accounting and Reporting System (CALSTARS) reports, which are needed to make the remittances.

We observed a similar weakness during our financial audit of fiscal year 1987-88. In May 1989, the department responded that it intended to meet with several large agencies that also use CALSTARS to determine how they cope with CALSTARS report delays. Also, the department responded that it would continue to explore ways to minimize the disruptive effects of staff turnover.

- 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

1988-89 logs, we found six inconsistencies between the two logs in the recording of check numbers. Also, we noted two instances, in November 1988 and June 1989, in which the beginning and ending check numbers listed in the checks-signed log included more checks than were actually signed. In addition, for 4 of 27 checks that we reviewed, the status of checks recorded in the the checks-written log did not agree with the status of the checks recorded 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 can not be certain that it can account for the entire blank-check stock.

We observed a similar weakness during our financial audit of fiscal year 1987-88. The department responded that it did not reconcile check logs because of high staff turnover. The department added that it is exploring methods to minimize the disruptions caused by staff turnover, including additional training and closer supervisory review.

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 and, for receipts of \$25,000 or more, requires the department to send notification no later than the first day of the week following the accumulation of that amount. 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 8081 and 8091.

Item 3. **Weakness in Controls Over Disbursements**

Finding: The department did not always maintain sufficient control over disbursements. Of the 48 claim transactions that we tested, 4 were for purchases made by the textbook distribution unit and the acquisitions section of the California State Library. For these 4 transactions, the department's

claim processing unit did not require that evidence of the receipt of the goods be submitted to the department's claims processing unit before the payment of the claims. Unless the department obtains such evidence before payment, the department may pay for goods or services that it did not actually receive.

Criteria: The State Administrative Manual, Section 8422.1, requires each agency to determine that goods or services have been received before payment is made.

Recommendation: The department should obtain evidence that it has received goods and services before it submits claims to the State Controller's Office for payment.

Item 4. Lack of Policy for Monitoring and Collecting Accounts Receivable

Finding: The department has not completed the development of written policies and procedures for monitoring and collecting accounts receivable. We observed a similar weakness during our financial audit for fiscal year 1987-88. The department responded that it planned to begin work on a written policy and accompanying procedures governing all accounts receivable and to include them in its administrative manual. The department's targeted date for completion was December 31, 1989. In February 1990, officials of the department stated that they expected to complete this project by June 30, 1990.

Unless the department develops and follows a policy for monitoring and collecting delinquent accounts receivable, it diminishes the control over its receivables and, thus, increases the risk that some receivables will become uncollectible.

Criteria: The California Government Code, Section 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 follow through on its plan to complete the policies and procedures for all accounts receivable.

Item 5.

Incorrect Calculation of Entitlement for the School Improvement Program

Finding:

The department did not calculate entitlements for the School Improvement Program for fiscal year 1988-89 in accordance with state statutes. In one of the nine entitlements that we reviewed for fiscal year 1988-89, the department gave the school district that was disallowed a cost-of-living adjustment, as determined by the California Education Code, Section 52048, the same amount of funding that it received in fiscal year 1987-88. However, according to our legal counsel's interpretation of the California Education Code, the department should have based its calculations of the funding for the School Improvement Program for fiscal year 1988-89 on the California Education Code, Section 52046(b)(1) and (2), which adjusts the previous year's funding by the student attendance figures. If the department maintains district entitlements at the funding level for fiscal year 1987-88, school districts with declining attendance would not have a decrease in entitlement.

We observed a similar weakness in our financial audits for fiscal years 1984-85, 1985-86, 1986-87, and 1987-88. In 1986, the department attempted to have legislation approved to amend these code sections; however, the governor vetoed this legislation on September 30, 1986. The department's attempt to clarify the intent of the code sections through explanatory language in the budget bill for fiscal year 1988-89 also was disallowed.

Criteria:

The California Education Code, Section 52046(b)(1) and (2), requires that, from funds appropriated, the superintendent is to make allowances to school districts with approved school improvement plans through implementation grants in the following amounts:

- \$148 per unit of average daily attendance (ADA) in kindergarten and grades 1, 2, and 3, or their equivalent, exclusive of ADA in summer school; and
- \$90 per unit of ADA in grades 4 through 8, or their equivalent, exclusive of ADA in summer school, regional occupational centers, and adult classes taken by regular high school pupils.

Recommendation: The department should seek the attorney general's interpretation of the California Education Code, Section 52046(b)(1) and (2) and Section 52048.

Item 6. Weakness in Distribution of Grants for the Drug-Free Schools and Communities Program

Finding: The department approved incomplete applications of local educational agencies (LEAs) for grants under the Drug-Free Schools and Communities program. Specifically, 15 of the 25 LEA applications we reviewed did not include a description of the practices and procedures that the LEA would enforce to eliminate the sale or use of drugs and alcohol on school premises. As a result, the department cannot ensure that these LEAs are using their grant in accordance with applicable federal laws and regulations.

Criteria: United States Code, Title 20, Section 3196(a)(1), requires a local or intermediate educational agency or consortium to submit an application to the State for approval to be eligible for a grant under the Drug-Free School and Communities Act of 1986. This section states further that the application must describe how the applicant will enforce its drug and alcohol policy.

Recommendation: The department should ensure that applications for grants under the Drug-Free School and Communities Act meet all federal requirements before they are approved.

Item 7. Poorly Documented Charges to Federal Grants

Finding: The department based certain charges to federal grants during fiscal year 1988-89 on a study it made in fiscal year 1983-84. Specifically, the department charged approximately \$350,000 to the Vocational Education Consumer and Homemaking grant and approximately \$35,000 to the Vocational Education Administration grant based on the outdated study. Although the department could not provide the study it used to calculate these percentages, it did provide us with the updated study it will use for fiscal year 1989-90 charges. Using the new study, we determined that the department may have undercharged the Vocational Education Consumer and Homemaking grant by as much as \$11,500 and overcharged the Vocational Education Administration grant by as much as \$11,500.

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: The department should completely document the methods it uses to split charges between federal grants and retain the supporting records for audit.

Item 8. Inconsistency in Resolving Instances of Noncompliance With Federal and State Laws and Regulations

Finding: The department is not consistently identifying and requiring 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, LEA, 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 110 audit reports for subrecipients' compliance with federal laws and regulations. Forty-three of these audit reports identified instances in which subrecipients did not comply with federal laws and regulations. Of these 43, 2 reported an instance of noncompliance that the department had not properly resolved. In addition, we reviewed 12 other subrecipient audit reports that identified instances of noncompliance with state laws and regulations. Of these 12, 2 reported an instance of noncompliance that the department had not properly resolved. Although the department determined that all 4 subrecipients needed to submit a corrective action plan to resolve the noncompliance issue, the department did not require them to do so.

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 a similar weakness during our financial audit of fiscal year 1987-88. The department responded that it had revised its procedures to resolve subrecipient audit exceptions more quickly.

Criteria: According to the federal Office of Management and Budget, Circular A-128, state or local governments that allocate \$25,000 or more of the federal financial assistance they receive in a fiscal year to a subrecipient must ensure that the subrecipient corrects instances of noncompliance with federal laws and regulations.

The California Education Code, Section 41020.6, requires the department to report annually the actions it has taken to eliminate audit exceptions and to comply with the recommendations in audit reports of subrecipients. We interpret this section to mean that the department must resolve instances of noncompliance identified in audit reports of subrecipients.

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

Item 9. Inconsistent Data on Processing Inventory Reports

Finding: The department reports inconsistent data on processing inventory reports, for the Food Distribution program, that it submits to the United States Department of Agriculture (USDA) each quarter. These reports record the inventory balances and the amount of donated foods processed by contractors that have processing agreements with the State. The report for the quarter ending December 1988 contained data for inventory balances and processing agreements from August 1986 through January 1989 instead of from October 1988 through December 1988.

We observed a similar weakness during our financial audit of fiscal year 1987-88. The department responded that it was revising its procedures to ensure that the content of these reports complies with the USDA requirements. However, the revised procedures were not in place at the time the report was prepared.

Criteria: The Code of Federal Regulations, Title 7, Section 250.30(o), states that the quarterly processing inventory reports should contain the processing activity during the quarter and the inventory balances at the close of the quarter for the federal fiscal quarter for which the department is reporting.

Recommendation: The department should comply with the requirements of the Code of Federal Regulations, Title 7, Section 250.30(o).

Item 10. Insufficient Monitoring of Subrecipients and Contractors That Participate in the Food Distribution Program

Finding: The department did not sufficiently monitor subrecipients and food processing contractors (contractors) that participate in the Food Distribution program. For example, the department did not perform the required number of compliance reviews. During fiscal year 1988-89, the department reviewed only 19 percent of charitable institutions and 18 percent of summer camps that participate in the program. Additionally, for 7 of the 24 subrecipients that we tested, the department did not perform compliance reviews within a five-year period, as required.

Also, the department did not require 4 of the 24 subrecipients that we reviewed to submit corrective action plans for instances of noncompliance noted during its compliance reviews. We observed a similar weakness during our financial audits for fiscal years 1986-87 and 1987-88. The department responded that it directed the appropriate unit manager to meet with field staff to discuss any instances of noncompliance that are not resolved within prescribed timelines.

Further, the department did not adequately document its compliance reviews of these subrecipients. For 18 of the 24 subrecipients that we reviewed, the department did not completely document its compliance review of the subrecipient's storage facilities, inventory system, and contracts with food-processing contractors.

In addition, the department did not promptly obtain from contractors information that it needed to monitor the contractors' donated foods inventory.

Specifically, the department did not require contractors to submit a reconciliation of their donated foods inventory at June 30, 1988, until September 30, 1989, one year after the reconciliation was due.

Officials of the department stated that they obtained the reconciliations late because the USDA could not provide guidance on the format and content of the required reconciliations. Further, the officials stated that during fiscal year 1988-89, they developed reconciliation forms acceptable to the USDA and required processors to submit the reconciliations for fiscal years 1987-88 and 1988-89 by September 30, 1989.

Criteria:

The Code of Federal Regulations, Title 7, Section 250.19(b)(1), requires that the State annually review not fewer than 25 percent of the charitable institutions and summer camps participating in the Food Distribution program. In addition, the Food and Nutrition Service Instruction 113-3, issued by the USDA on December 16, 1982, requires that the State review recipient agencies receiving donated foods 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. In our opinion, monitoring procedures that include prompt follow-up on areas of noncompliance noted during compliance reviews would be important elements of a satisfactory system of administrative controls.

The Code of Federal Regulations, Title 7, Section 250.30(n), requires that the State monitor contractor inventories to ensure that the quantity of donated foods for which a contractor is responsible is maintained at the lowest cost-efficient level. This section further states that the State must obtain an annual reconciliation of the processor's inventory of donated foods and that the processors must submit these reconciliations within 90 days after their processing agreement expires.

Recommendation: The department should perform the required number of monitoring reviews and fully document each review. The department should also obtain from the subrecipients the reports that it needs to meet the monitoring requirements. Finally, the department should require subrecipients to submit corrective action plans for instances of noncompliance noted during its compliance reviews.

Item 11. **Inaccurate Federal Report for the School Lunch and Breakfast Programs**

Finding: The department made errors in preparing the fiscal year 1987-88 Assessment, Improvement, and Monitoring System data report (report) that it submitted to the USDA. The report lists 92 statistics on the results of the department's fiscal year 1987-88 administrative reviews of school food authorities. The statistics include the number of administrative reviews the department completed, the number of violations the department detected, and any changes in reimbursements resulting from the violations identified.

Forty-one of the 92 statistics the department reported to the USDA were inaccurate. Also, 29 of the 92 statistics lacked supporting documentation. For example, the department reported that it determined during its first administrative review that school lunch and breakfast sponsors overclaimed approximately 55,000 free and reduced-price meals; however, the department's records show it actually determined that sponsors overclaimed approximately 1,482,000 free and reduced-price meals.

The USDA uses this report to compare the effectiveness of the department's administrative reviews from year to year. However, since some of the statistics in the report were inaccurate, the USDA cannot rely on them to determine the effectiveness of the department's administrative review of school food authorities.

Criteria: The Code of Federal Regulations, Title 7, Section 210.18(1)(2), requires that each state agency report to the USDA the results of its administrative reviews of school food authorities from the previous school year.

Recommendation: The department should ensure that it completes the Assessment, Improvement, and Monitoring System data report accurately and retains sufficient supporting documentation.

Item 12. Late Federal Reports for the Vocational Education Program

Finding: The department did not submit Vocational Education program reports to the federal government on time. For example, the department's 1987-88 annual performance report was submitted approximately eight months after the due date of December 31, 1988. In addition, for the past three fiscal years, the department has not submitted its final federal financial status report on time: the department submitted the reports for fiscal years 1985-86 and 1986-87 approximately 19 and 12 months late, respectively, and, as of January 31, 1990, the department had not yet submitted its report for fiscal year 1987-88, which was due December 31, 1989.

The department submitted these reports late primarily because the California Community Colleges, Chancellor's Office, which jointly administers the program, was late transmitting its data to the department.

We observed similar weaknesses during our financial audits for fiscal years 1983-84 through 1987-88. The department responded that internal reorganization and delays in receiving information from the Chancellor's Office were the reasons for the late annual performance report. Also, the department responded that delays in receiving expenditure reports from the Chancellor's Office and LEAs was the reason for the late final financial status report. To ensure that future final financial status reports are submitted on time, the department responded that it established due dates for reports from the Chancellor's Office and is aggressively following up on LEAs that are delinquent in filing expenditure reports.

Criteria: The Code of Federal Regulations, Title 34, Section 74.82(b), states that annual performance reports are due 90 days after the end of the grant year.

The Code of Federal Regulations, Title 34, Section 74.73(d), states that, when required on an annual basis, financial status reports are due 90 days after the grant year.

The Code of Federal Regulations, Title 34, Section 76.722, provides that a state may require a subrecipient to furnish reports that a state needs to carry out its responsibilities under the program. The department established a deadline of September 30, 1989, for LEAs to submit final expenditure reports for fiscal year 1988-89.

Recommendation: The department should submit required federal reports on time.

Item 13. **Late Final Status Report for the Job Training Partnership Act Program**

Finding: The department did not complete on time its final status report for the Job Training Partnership Act program. The department administers a portion of the Job Training Partnership Act program for the Employment Development Department through an interagency agreement. The Employment Development Department requires the department to submit the final status report within 90 days after receiving the instructions and other reporting information from the Employment Development Department. The department should have submitted the report by September 30, 1989, but it did not require the program's subrecipients to submit their expenditure reports and other year-end reports until September 30, 1989. Subrecipients' expenditure reports and other year-end reports include information necessary for the department's final status report. The department completed the final status report on February 5, 1990.

We observed a similar weakness during our financial audit for fiscal year 1987-88. The department responded that it was negotiating with the Employment Development Department to establish more effective timelines. For fiscal year 1988-89, officials of the department stated that they requested approval, in writing, of a later submission date for the final status report but that it had not yet received written approval.

Criteria: The Code of Federal Regulations, Title 20, Sections 629.35 and 629.36, establishes reporting requirements for the Job Training Partnership Act. Further, in a memo to the department dated June 28, 1989, the Employment Development Department directed the department to submit the final status report and other reporting information by September 30, 1989.

Recommendation: The department should continue to work with the Employment Development Department to develop reporting deadlines with which the department can comply.

Item 14. **Control Procedures Not Followed for the Handicapped--State Grants Program**

Finding: The department did not withhold current year funds from three Special Education Local Plan Areas (SELPAs) participating in the federal Handicapped--State Grants program even though they had not submitted required information. For example, the department paid one SELPA 50 percent of its fiscal year 1988-89 grant before receiving the SELPA's fiscal year 1987-88 final expenditure report. Because the SELPA did not submit its final expenditure report, the department should have withheld payment of the SELPA's current year funds until the SELPA submitted the report. Further, the department paid two SELPAs 50 and 100 percent of their fiscal year 1988-89 grant before receiving from them a signed Certification of Acceptance of Grant Conditions. The department may jeopardize its ability to properly monitor the SELPAs' use of federal grant monies and to enforce pertinent federal laws and regulations when it does not follow its own control procedures.

Criteria: The Code of Federal Regulations, Title 34, Section 76.101(e)(1), requires the State, in its application for funds from the Handicapped State Grants program, to give assurances that it will administer the program in accordance with all applicable statutes, regulations, state 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. The department specifies in its special grant conditions

that the failure of a SELPA to submit its prior year expenditure report will result in the withholding of current year advances.

Recommendation: The department should adhere to its control procedures for payments to SELPAs.

Item 15. Late Reports and Lack of Prompt Follow-Up on Fiscal Reviews for the Migrant Education Program

Finding: The department did not promptly issue reports and follow up on problems that it identified during its fiscal review of the operating agencies participating in the migrant education program. Further, the department did not require some of the operating agencies to submit necessary corrective action plans. We noted the following specific deficiencies:

- The department identified problems at 16 of the 18 operating agencies that it reviewed between March 1989 and June 1989. The department did not promptly issue a report to 6 of these agencies, took from four to seven months to issue its report to 5 agencies, and as of January 1990, had not yet issued a report to the remaining agency.
- The department did not require 10 of the 16 operating agencies with deficiencies to submit plans to correct problems it identified during the fiscal reviews. Although the department required the other 6 operating agencies to report on corrective action taken within 60 days of the date of the department's report, the department did not follow up on 3 of the 6 agencies that did not respond within the 60 days. Of these 3, one responded after 89 days and the other 2 still had not responded to the department as of January 1990.

Without prompt follow-up, the department cannot ensure that the operating agencies are correcting problems identified in the fiscal reviews.

We reported a similar weakness during our financial audit for fiscal year 1987-88. The department responded that it would update its fiscal review process to include new steps to notify operating agencies of recommendations and of required corrective action during the exit interviews and in

the reports sent to the agencies. The agencies would have 60 days from the final report date to respond.

Criteria: The Code of Federal Regulations, Title 34, Section 201.12(a)(3)(i), requires the State to include in its State Plan procedures on how it will ensure that operating agencies spend migrant funds in accordance with their approved applications. The State Plan identifies fiscal reviews as the procedure used to monitor this expenditure. Further, the federal Office of Management and Budget, Circular A-128, requires the State to determine whether subrecipients are spending federal grant money in accordance with applicable laws and regulations. We interpret this requirement to include prompt issuance of final reports and follow-up on problems noted during the fiscal review process.

Recommendation: The department should issue final reports to the operating agencies promptly following its annual fiscal reviews. Also, the department should require operating agencies to respond to recommendations in the report by submitting corrective action plans. Further, the department should follow up when operating agencies do not submit corrective action plans on time.

Item 16. Noncompliance With Certain Federal Requirements

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

- For 44 of 364 claims that we reviewed, the department held the related federal grant funds from 6 to 45 working days before disbursement to subrecipients. The average number of days between receipt and disbursement of these 44 claims was 8.9 days. However, the average number of days between receipt and disbursement of funds for all claims that we reviewed was only 3.6 days. Also, for 18 other claims, the department disbursed money from one to 9 days before receiving the federal grant money. For these 18 claims, the average number of days between disbursement and receipt of the federal grant money was 2.6 days. 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 disbursements by the recipient organization. We observed a similar weakness during our financial audit for fiscal year 1987-88.

- The federal cash transaction report for the quarter ending June 30, 1989, did not reconcile to the department's accounting records by approximately \$1,300. Circular A-128 of the federal Office of Management and Budget requires that federal reports contain information that is supported by the agency's accounting records.
- The department allocated indirect costs for all federal programs during fiscal year 1988-89 using different rates than those it had submitted to the federal government in its fiscal year 1988-89 Provisional Indirect Cost Rate Proposal. Although the department did not submit the revised rates to the federal government for approval, on December 14, 1989, it submitted its Final Indirect Cost Rate Proposal based on actual expenditures. Circular A-87 of the federal Office of Management and Budget requires state agencies to submit a plan for allocation of direct costs to the cognizant federal agency for approval.
- The department allowed six years to elapse between administrative reviews of a sponsor participating in the Child Care Food Program. The Code of Federal Regulations, Title 7, Part 226.6(k)(1), requires state agencies to conduct administrative reviews of participating sponsors at least once every four years.
- For 3 of the 20 school lunch and breakfast program sponsors that we reviewed for fiscal year 1988-89, the department allowed up to approximately two months beyond the 90 days to elapse before completing the closing review. In addition, for 4 of the 17 closing reviews that we reviewed for the four fiscal years before 1988-89, the department also did not meet the 90-day requirement. 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 exit conference of a review. State agencies may extend this deadline to 90 days. We observed a similar weakness during our financial audit of fiscal year 1987-88.

- The department submitted the Food Distribution Program processing inventory report to the United States Department of Agriculture one to seven days late for each quarter during the 1988 calendar year. The Code of Federal Regulations, Title 7, Section 250.30(o), states that the processing inventory reports are due within 60 days after the end of each quarter.
- The department's school lunch and breakfast program submitted the Assessment, Improvement, and Monitoring System data report for fiscal year 1987-88 to the United States Department of Agriculture two days late. The Code of Federal Regulations, Title 7, Section 210.18(1)(2), states that this report is due on March 1 of each year.
- Because of a clerical error, the department underallocated an LEA \$3,200 of Vocational Education Single Parent federal funds. The Code of Federal Regulations, Title 34, Section 401.100, requires the State to establish its own criteria for distributing funds under the Vocational Education Single Parent program. Further, the department's Vocational Education Administrative Provisions, Section 3, states that funds will be allocated to the LEA on the basis of the number of single parents living below the poverty level in the LEA's geographic area.
- The department submitted the federal cash transaction report for the quarter ending December 31, 1988, to the United States Department of Education seven days late. The Code of Federal Regulations, Title 34, Section 74.74(d), states that the cash transaction report is due within 15 working days after the end of each quarter. We observed a similar weakness during our financial audit for fiscal year 1987-88.

Although individually these deviations may not appear to be significant, they do represent noncompliance with federal regulations, 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.

Item 17.

Noncompliance With Certain State Requirements

Findings and
Criteria:

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

- For 11 of 30 cash receipts that we reviewed, the department deposited the receipts one to 16 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 by the next working day.
- Two of the 12 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 and, therefore, clear travel advances from the records when employees submit their travel-expense claims. We observed a similar weakness during our financial audit for fiscal year 1987-88.
- The department does not sufficiently document the calculation of Project Workability grants for sites existing before fiscal year 1988-89. The California Education Code, Section 56471(c), states that the department must develop criteria for awarding grants. We observed a similar weakness during our financial audit for fiscal year 1987-88.

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

AGRICULTURAL LABOR RELATIONS BOARD

We reviewed the financial operations and related internal controls at the Agricultural Labor Relations Board (ALRB).

Item 1. Insufficient Control Over the Agency Trust Account

Finding: The ALRB does not regularly identify and record the amounts due from agricultural employers in its Agency Trust Account. The ALRB maintains the Agency Trust Account for agricultural employers' payments, which are to be distributed to agricultural employees under the terms of settlements of unfair labor practices. The ALRB's three regional offices are responsible for monitoring the payment of these settlements. Although the ALRB's central office maintains a list of the payments made, it does not maintain a schedule that shows the balance that employers owe. In addition, the ALRB does not record these balances as receivables and payables in its financial statements.

As a result of these weaknesses, the ALRB did not record \$176,137 in receivables, and a corresponding payable to agricultural employees, in its Agency Trust Account as of June 30, 1989. Moreover, the central office has no assurance that the regional offices have procedures to collect all amounts owed by employers. Finally, failure to establish an effective system of internal accounting controls over the employer accounts could result in undetected errors or irregularities.

Criteria: The California Government Code, Section 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. Moreover, the State Administrative Manual, Sections 7605 and 7610, indicates that all funds should establish an account for receivables. As a result, we conclude that the ALRB should use its receivables account to record the amounts owed by employers.

Recommendation: The ALRB should establish and maintain a schedule of employer accounts that identifies the balance of each account. In addition, the ALRB should record these balances as receivables and payables in its Agency Trust Account.

Item 2.

Inaccurate Analysis and Reporting of Payables and Encumbrances

Finding:

The ALRB did not accurately analyze and report payables and encumbrances at June 30, 1989, for its portion of the State's General Fund. For example, the ALRB incorrectly reported \$7,311 as encumbrances although it had already received the goods and services before June 30. This amount should have been included in payables since encumbrances represent commitments for goods or services to be received after June 30. In addition, the ALRB incorrectly reported one item amounting to \$35,153 as a payable instead of an encumbrance even though it did not receive the goods until after June 30.

As a result of these errors, the ALRB reported incorrect amounts of payables and encumbrances to the State Controller's Office as of June 30, 1989. The ALRB overstated its payables and understated its encumbrances by \$27,842. 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.

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.

Recommendation:

The ALRB should determine whether it receives goods or services before or after June 30 and appropriately report amounts owed as payables or encumbrances.

OFFICE OF CRIMINAL JUSTICE PLANNING

We reviewed the internal audit unit of the Office of Criminal Justice Planning (office).

Item **Late Audit Reports**

Finding: In our review of the office, we found that its internal audit unit did not issue the unit's reports promptly. Specifically, from May 1988 to April 1989, the unit completed four audits and issued the reports for two of these audits, one of which was issued seven months after the fieldwork ended. As of the end of our review, the unit still had not issued reports for the two other audits, although the audits had been completed in June 1988 and August 1988. The chief of the unit stated that the audit reports were not issued promptly because of frequent employee turnover. Because the unit did not issue the reports promptly, the auditees may not be aware of the problems existing in their programs and, therefore, they could not promptly implement the unit's recommendations.

Criteria: The SPPIA, Sections 430.01 and 430.03, requires that the unit issue a timely report upon completion of an audit.

Recommendation: The office should require the unit to establish procedures to ensure that reports are issued promptly.

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 13.789 and 13.792.

Item 1. Requests for Federal Funds Exceeded Immediate Needs

- Finding:** The department requested federal funds in excess of its immediate needs for the LIHEAP and CSBG programs. During fiscal year 1988-89, it requested federal funds an average of 20 to 26 days before the funds were disbursed to pay the department's expenditures, and it maintained an average cash balance of \$6 million to \$8 million in federal funds. In one instance, on February 3, 1989, the State Controller's Office received approximately \$15.5 million in federal funds that the department had requested to pay expenditures. However, the State Controller's Office did not disburse approximately \$11 million of this amount on the department's behalf until February 17, 1989. 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 advance financing by the federal government. We reported a similar weakness in our audit for fiscal year 1987-88.
- 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.

Item 2.

Improper Accounting for and Collection of 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:

- The department could 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 \$572,000, were valid accounts receivable;
- The department has not taken active steps to collect long-outstanding receivables. Four of the ten items we reviewed, totaling \$282,194, have been outstanding at least 14 to 24 months. The department has no record of sending the agencies subsequent collection notices to remind them of their liability after initially billing the contractors and, consequently, may not be collecting all amounts owed to it;
- The department has not properly evaluated the accounts receivable account to identify items that are not collectible. For example, one of the contractors we tested with four outstanding receivables, totaling \$512,064, notified the department that it was bankrupt. Since the department probably cannot collect these receivables and should request permission from the Board of Control to remove the receivables from the accounts receivable account, the accounts receivable account may be overstated by this amount; and
- The department does not always properly review its contingent receivable account. Contingent accounts receivable are amounts the department believes contractors might be required to return to the department. The department determines these amounts during audits of the contractors. If the contractors subsequently provide documentation to justify the questioned costs, the contingent receivable is eliminated. However, if the contractor does not provide documentation to support the costs, the department will normally reclassify the amount to the accounts receivable category.

However, we found that the department had incorrectly classified one item for \$31,014 as a contingent receivable instead of an accounts receivable even though at year end the department had documentation to support making the change. Since the department had not reclassified this item as an accounts receivable, it did not send an invoice to the contractor. If the department does not periodically review the contingent receivable account to determine whether the questioned costs have been adequately justified, it cannot identify all amounts owed to it and may misstate the account at year end.

Criteria: The State Administrative Manual, Section 7951, states that agencies should retain detail to support general ledger account balances as of June 30 for use by auditors. 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. Finally, the department should develop procedures to periodically review its contingent receivables.

Item 3. Insufficient Monitoring of Contractors

Finding: The department does not always sufficiently monitor contractors that receive federal funds under the LIHEAP and CSBG programs from the department. Specifically, it does not require contractors to submit their corrective action plans for instances of noncompliance noted during its compliance reviews by the dates specified in the compliance reports. Four of the 10 contractors we reviewed did not adhere to the due dates for corrective action that the department specified in the compliance reports. For example, in June 1989, the department reported five instances of noncompliance for one of the four

contractors we reviewed. However, this contractor did not submit a corrective action plan for three of the five instances until February 1990. In its compliance report, the department specified to this contractor that corrective action was required immediately for one of the three instances and by July 31, 1989, for the remaining two of the three instances. Because the department does not enforce its requirement that contractors submit corrective action plans by the dates specified on the compliance review, the department cannot ensure that the contractors have promptly corrected instances of noncompliance.

Criteria: The California Government Code, Section 13402, requires state agencies to establish and to maintain a system of administrative controls. According to the California Government Code, Section 13403, these administrative controls are methods that ensure that measures to safeguard assets, promote operational efficiency, and encourage adherence to prescribed managerial policies are being followed. It is the department's policy to require contractors to submit plans for corrective action for instances of noncompliance noted during the compliance reviews by the date that the department specifies in its compliance reports.

Recommendation: To ensure that contractors are in compliance with federal and departmental regulations, the department should enforce its policy requiring contractors to submit corrective action plans by the dates specified in the compliance reports.

DEPARTMENT OF FINANCE

We reviewed the internal audit unit of the Department of Finance (department).

Item 1. Deficiencies in Audit Reports

Finding: The department's Financial and Performance Audits Unit does not present the proper scope of review in its reports on its quality control reviews of the State's internal audit units. Specifically, the reports state that the purpose of the quality control review is to determine that the State's internal audit units conduct their study and evaluation of internal control and fiscal compliance in accordance with the SPPIA. Thus, these reports imply that the unit reviews the independence, scope of work, performance of work, management, and qualifications of the State's internal audit units. However, the unit only reviews the performance of work of the internal audit units. As a result of not presenting the proper scope of review, the unit's reports may mislead readers that the reviews encompass all five standards.

We also found that the unit does not always issue the results of its reviews promptly. For example, in our review of six audit assignments, we found that the unit did not issue two reports until five months after the end of the fieldwork. As a result, the auditees (state departments) may not be aware of problems in their internal audit units or implement the unit's recommendations promptly.

Criteria: The SPPIA, Section 430.04, requires the unit to present the audit scope in its audit reports. Further, Sections 430.01 and 430.03 require the unit to issue a timely report upon completion of an audit.

Recommendation: The department should require the unit to revise its report format to include the specific scope of its review. In addition, the department should ensure that the unit issue its reports promptly after the completion of the audit.

Item 2.

Insufficient Quality Control Procedures

Finding:

The unit's quality control procedures do not ensure that the unit's work complies with all the SPPIA. For instance, in our review of six audits, we found that, after reviewing the internal control of Sonoma State University (university), the unit reported that the university's internal accounting control and fiscal procedures were adequate. However, the unit did not review the controls over the university's electronic data processing (EDP) system. A review and evaluation of the overall adequacy and effectiveness of a system of internal controls include a review and evaluation of controls related to EDP. Unless the work of the auditors is reviewed sufficiently, audit management are not assured that the auditors have met all the audit objectives.

We also found that, during its review of the Department of Developmental Services' (DDS) regional centers, the unit did not follow up on its previous audit recommendations as it stated it would in its engagement letter to the DDS. Failure to disclose a change in the scope of an audit may mislead the auditee and the audit management that the audit objectives stated in the engagement letter were met. We believe that these deficiencies could have been identified if the unit had effective quality control procedures.

Criteria:

The SPPIA, Section 560, requires the unit to establish and implement a quality control program that includes the continual supervision of the internal auditor's work to assure conformance with the SPPIA, departmental policies, and audit programs.

Recommendation:

The unit should implement a quality control program that would ensure the quality of the unit's work.

Item 3.

Lack of Performance Evaluations For Audit Staff

Finding:

The unit does not always perform annual performance evaluations of its audit staff. We found that 14 out of the 30 auditors who had worked in the unit one year or longer did not have the required performance evaluations within the past 12 months. The primary objectives of staff performance evaluations are to appraise staff performance, to identify training needs, and to promote audit

staff. Without annual performance evaluations, the audit staff may not be aware of their professional training needs.

Criteria: The SPPIA, Section 540.01.4, requires the unit to appraise each audit employee's performance at least annually.

Recommendation: The department should require the unit to evaluate auditors' performance annually.

DEPARTMENT OF FOOD AND AGRICULTURE

We reviewed the internal audit unit of the Department of Food and Agriculture (department).

Item The Organizational Placement of the Internal Audit Unit Impairs Its Independence

Finding: The organizational placement of the internal audit unit within the department impairs the unit's independence. Specifically, the unit is organizationally under the assistant director of the Administrative Services Division, who also has authority over the activities of accounting, budget, human resources, departmental services, electronic data processing (EDP), and other support units that the internal auditors are required to review. For example, the internal auditors are required to review the internal controls associated with accounting and EDP within the department. Nevertheless, both the internal auditors and the staff of accounting and EDP report to the assistant director of the Administrative Services Division. As a result, the assistant director could influence the scope of the internal audit and its recommendations related to the activities under her supervision.

We reported a similar weakness in our report entitled "The State of California Should Improve Its Internal Audit Capabilities," Report F-499, July 1986. In its response to our report, the department indicated that it would not change the organizational placement of the unit. However, the department indicated that audit reports on internal audits involving financial activities administered by the assistant director of the Administrative Services Division would be addressed to the director of the Department of Food and Agriculture.

As noted above, the department has made improvement in the reporting procedures of the unit. While this change contributes to greater independence, it still does not fully promote the concept of independence. For example, because the chief of the unit continues to report to the assistant director of the Administrative Services Division, others may question the unit's independence. Additionally, the

assistant director's supervisory duties, which include evaluating the job performance of the chief of the unit, may affect the actions of the unit.

Criteria: The SPPIA, Section 110.01.1, requires that the chief of the unit be responsible to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.

Recommendation: The department should place the unit under the authority of either the director or the chief deputy director of the department.

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 13.633 and 13.635.

Item 1. Insufficient Monitoring of the Area Agencies on Aging

Finding: The department did not conduct annual performance evaluations of all the area agencies on aging. Specifically, the department did not conduct on-site performance evaluations of the supportive services of 17 of the 33 area agencies during fiscal year 1988-89 and has not conducted these evaluations for 5 of the area agencies for at least two years. Furthermore, the department did not conduct on-site performance evaluations of the nutrition services of 25 of the 33 area agencies during fiscal year 1988-89 and has not conducted these evaluations for 11 of the area agencies for at least two years. Failure to conduct annual 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, requires the department to conduct on-site performance evaluations of area agencies annually.

Recommendation: The department should conduct on-site performance evaluations of all the area agencies on aging annually.

Item 2. Noncompliance With Certain State Requirements

Findings and Criteria: We noted the following instances where the department did not always comply with administrative requirements of the State.

- During fiscal year 1988-89, the department did not promptly submit plans of financial adjustments (PFA) to the State Controller's Office every month. The State Administrative Manual, Section 8456, requires the department to submit PFAs to the State Controller's Office monthly.
- The department did not perform annual audits of 28 of the 34 sponsors of the Brown Bag program during fiscal year 1988-89. Furthermore, the department has not audited 18 of the 28 sponsors for at least two years. The Welfare and Institution Code, Section 9602(c), requires the department to perform annual audits of the Brown Bag program.

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 improve its compliance with each of the state requirements.

DEPARTMENT OF ALCOHOL AND DRUG PROGRAMS

We reviewed the Department of Alcohol and Drug Programs' (department) administration of the U.S. Department of Health and Human Services grant, Federal Catalog Number 13.992.

Item 1. Incomplete Documentation of County Alcohol Program Reviews and Insufficient Follow-up Procedures

Finding: The department's division of alcohol programs does not adequately document its reviews of county alcohol programs. Additionally, the division is not following its established procedures for following up on a county that had not issued a plan to correct deficiencies within the 45-day deadline for county response. As a result of these weaknesses, the division is unable to substantiate that it has complied with its own requirements for evaluating entities that receive federal funds. The division reviews county alcohol programs and reports its findings to the counties. We reviewed 11 of the reports of county alcohol programs that the division completed during fiscal year 1988-89 and found the following specific deficiencies:

- Ten of the 11 reports that we reviewed did not contain complete documentary evidence to show that the division examined all aspects of the county program. For the ten reports, the division did not completely fill out the Administrative Standards and Review Instrument (instrument), which details the results of the review. For example, in the worst case, the division did not answer 42 of 194 questions in the instrument. Therefore, we cannot determine that the division examined these areas. Further, we cannot determine that the division has identified all weaknesses in the county alcohol program;
- Five of the 11 reports reviewed contained a total of 12 findings that were not supported by the division's responses in the instrument. In one example, the division's report to a county included a recommendation that the county program should clarify the written policy and procedure for substantiating compliance with civil rights and confidentiality laws. However, the division's responses in the

instrument noted that the county program's written policy and procedures were acceptable; and

- For one of the 11 reports reviewed, the division did not follow procedures to ensure that the county submitted a plan to correct deficiencies within the 45-day period allowed for county response. Although the division completed the report on June 7, 1989, it had not, as of February 1, 1990, received the county's plan to correct deficiencies, and the division had not performed any follow-up procedures with the county to obtain the plan.

We observed similar weaknesses during our compliance audit for fiscal year 1987-88. The department responded that it would develop a checklist to verify that all documents supporting an administrative review are included in the review file. Additionally, the department noted that the division would modify its status report to ensure that follow-up is provided when action plans are required. However, the division has not successfully implemented these actions.

Criteria: 42 United States Code, Section 300w-4(c)(2), requires that the State agree to establish reasonable criteria to evaluate the effective performance of entities that receive funds from the State under this code. To accomplish this objective, the department has developed the Administrative Standards and Review Instrument to document the division's administrative reviews of county programs. To effectively comply with the objective, the division should complete each question in the instrument, support each finding it reports to the counties, and adequately follow up on findings reported.

Recommendation: The department should complete the Administrative Standards and Review Instrument for each review, support each finding it reports, and follow up on the findings it reports.

Item 2. County Alcohol Programs Not Reviewed Promptly

Finding: The department's division of alcohol programs does not perform on-site reviews of county alcohol programs promptly. We found that the division had not performed reviews of 10 of 58 counties receiving

federal alcohol abuse funding within the last two fiscal years as required. The division had not performed reviews for 9 of the 10 counties since fiscal year 1986-87, and it had not reviewed one of the 10 counties since fiscal year 1985-86. As a result, the department may not be aware of possible noncompliance with federal or departmental requirements at the county level, such as the federal requirements related to civil rights and confidentiality issues.

Criteria: 42 United States Code, Section 300w-4(c)(2), requires that the State agree to establish reasonable criteria to evaluate the effective performance of entities that receive funds from the State under this code. These criteria are identified in the County Administrative Review Procedures Manual. Section IV of this manual states that the division must meet these criteria by reviewing each county alcohol program once every two years.

Recommendation: The department should review county alcohol programs at least once every two years.

Item 3. **Incomplete Documentation of County Drug Program Reviews and Insufficient Follow-up Procedures**

Finding: The department's division of drug programs does not adequately document its reviews of county drug programs. In addition, the division does not always follow its established procedures for following up on a county that has not issued a plan of corrective action within the 60-day deadline for responses. As a result, the department is unable to substantiate that it has complied with its own guidelines for evaluating entities that receive federal funds. We reviewed six of the reports of the county reviews that the division completed during fiscal year 1988-89 and found the following specific deficiencies:

- None of the six reports we reviewed contained complete documentary evidence to show that the division examined all aspects of the county program. In all six reports, the division did not completely fill out the Manual for Monitoring County Operations (manual), which details the results of the review. For example, in the worst case, the division did not answer 181 of 249 questions in the manual.

Therefore, we cannot determine that the division examined these areas;

- One of the six reports reviewed contained a finding that was not supported by the division's responses in the manual. The division's report to the county included a recommendation that the county program should have written policies and procedures for quality assurance, but the division's responses in the manual made no mention of the lack of written policies and procedures;
- Two of the six reports did not contain recommendations that, according to the supporting documentation, should have been included, based on the division's responses in the manual. For example, in one review, the division noted in the manual that the county's advisory board had not received any formal training regarding drugs, drug abuse, and treatment/prevention strategies. However, the division did not report this weakness or make any recommendations about it in the report to the county; and
- For one of the six reports, the division did not follow its procedures to ensure that the county submitted plans to correct deficiencies within the 60-day period allowed for county response.

We observed similar weaknesses during our compliance audits for fiscal years 1986-87 and 1987-88. The department responded that division analysts would complete all portions of the manual. If a portion of the manual is not applicable, the analyst would note the reason and line through the page. Additionally, the department responded that the division would establish sufficient procedures to follow up on all county deficiencies. However, the division has not successfully implemented these actions.

Criteria:

42 United States Code, Section 300w-4(c)(2), requires that the State agree to establish reasonable criteria to evaluate the effective performance of entities that receive funds from the State under this code. To accomplish this objective, the division has developed the Manual for Monitoring County Operations to document each

county's performance. To effectively comply with the objective, the division should complete each question in the manual, support each finding in its reports to the counties, report each finding it identifies, and adequately follow up on findings reported.

Recommendation: The department should complete the Manual for Monitoring County Operations, support each finding it reports, report each finding it identifies during county drug program reviews, and follow up on the findings it reports.

Item 4. **County Drug Programs Not Reviewed Promptly**

Finding: The department's division of drug programs does not perform reviews of county drug programs promptly. We found that the division had not performed reviews for 28 of the 58 counties receiving drug abuse funding within 18 months as required. For example, as of June 30, 1989, the division has not performed reviews of 10 of the 28 counties since fiscal year 1986-87, and it has not performed a review of one of the 28 counties since fiscal year 1985-86. As a result, the department may not be aware of any possible noncompliance with federal and departmental requirements at the county level such as the federal requirements relating to civil rights and confidentiality issues.

Criteria: 42 United States Code, Section 300w-4(c)(2), requires that the State agree to establish reasonable criteria to evaluate the effective performance of entities that receive funds from the State under this code. These criteria are identified in the Manual for Monitoring County Operations, which specifically requires a comprehensive review of the county's management of its drug abuse services every 18 months.

Recommendation: The department should review county drug programs at least once every 18 months.

Item 5. **County Programs Not Reimbursed Promptly**

Finding: The department does not always reimburse county alcohol programs and county drug programs promptly. For 6 of 12 county alcohol programs we reviewed, the department exceeded its 60-day payment deadline by 11 to 84 days. Additionally, for 9 of 15 county

drug programs we reviewed, the department exceeded its 60-day payment deadline for nonMediCal counties and its 90-day payment for MediCal counties by 1 to 93 days. As a result, the county programs are without the federal funds to reimburse applicable program costs.

We noted similar weaknesses during our compliance audits for fiscal year 1986-87 for both the alcohol and drug programs, and for fiscal year 1987-88 for drug programs. The department responded that it would develop procedures for prompt reimbursement of the counties. However, it has not successfully implemented these procedures.

Criteria: The department's memorandum dated July 24, 1987, states that, except for counties receiving MediCal funds, it takes no longer than 60 days to review and approve claims submitted by the counties. Additionally, the department's division of drug programs has determined that it should take no longer than 90 days to review and approve claims submitted by counties receiving MediCal funds.

Recommendation: The department should ensure that it reimburses county programs within the deadlines it has established.

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.

Item 1. Failure To Refund All Tax Overpayments Owed to Employers

Finding:

The department has failed to refund all tax overpayments owed to employers. We reviewed the accounts of 113 employers to whom the department owed approximately \$10 million in tax refunds as of June 30, 1989. For 17 of the 113 accounts, the department withheld approximately \$68,800 in refunds owed to employers for as long as two and one-half years. The department's failure to issue refunds may cause some employers unnecessary hardship. In addition, amounts not refunded to employers revert to the State after three years, allowing the State to retain amounts that were payable to employers.

The department failed to refund overpayments to employers because of programming deficiencies in the department's Tax Accounting System (TAS). The following deficiencies in the TAS prevented or delayed the department's processing of all refunds owed to employers.

- Amounts Held in Trust Prevent Refunds

In ten of the employer accounts that we reviewed, the TAS placed in employers' trust accounts amounts that resulted from a difference in the way the TAS calculated employers' disability insurance tax liability and the way the employers calculated this liability. The TAS rounds amounts to whole dollars while the employers calculated amounts to exact dollars and cents. Placing amounts in employers' trust accounts protects the interests of employees to whom significant amounts are owed. However, before December 1988, when the department was holding even insignificant rounding differences in the employers' trust accounts, the department would not refund any tax overpayments until employers certified that the amounts in trust were not

owed to employees. For example, because the TAS placed a rounding difference of only \$.01 in one employer's trust account, the department did not refund a tax overpayment of approximately \$46,000 owed to that employer.

We also observed this condition during our financial audit of the department for fiscal year 1987-88. In response to our recommendation, the department implemented programming changes in December 1988 to allow processing of refunds when an amount less than \$10 exists in an employer's trust account. However, the programming changes were not retroactive and failed to identify and process previous overpayments that the department should have refunded to employers. The department plans to identify the employer accounts with long-outstanding overpayments and refund all overpayments that the department has withheld.

- Overpayments Lacking Current Refund Dates

In seven of the employer accounts that we reviewed, the TAS failed to assign a refund reason code during the processing of the overpayments. Without a refund reason code, the TAS does not establish a refund date, which delays the department's processing of refunds owed to the employers. For example, the department failed to refund amounts owed to one employer for as long as ten months. As a result of our review, the department plans to change the TAS programming to ensure that the TAS assigns refund reason codes to all overpayments at the time of processing.

Criteria: The Unemployment Insurance Code, Section 1177, requires the department to refund contributions, penalties, and interest that the director determines have been erroneously or illegally collected if the amount does not include refundable worker contributions.

Recommendation: The department should identify and refund to employers all tax overpayments that the department has withheld and should implement its proposed changes to the TAS to ensure that the department properly refunds all tax overpayments to employers.

Item 2.

Late Federal Financial Reports

Finding:

The department did not submit the Unemployment Insurance Financial Transaction Summary reports to the federal government within the time limit of ten business days for any of the months during fiscal year 1988-89. The department submitted the reports as late as two months after the required time limit. The department stated that it cannot submit the Unemployment Insurance Financial Transaction Summary reports on time because it cannot summarize the information within the required time limit. Failure to submit these reports on time 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 five previous fiscal years. The department reports that, once it has fully implemented the automated benefit accounting system and the single client data base, it will be able to submit the Unemployment Insurance Financial Transaction Summary reports within the required time. The department expects to fully implement these systems during 1990 and to begin submitting the reports on time by June 1991.

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.

Recommendation:

The department should continue to automate its accounting systems so it can submit the Unemployment Insurance Transaction Summary reports within ten business days after the end of each month.

Item 3.

Categories of Unemployment Insurance Deposits and Disbursements Incorrectly Reported

Finding:

The department did not correctly report certain categories of deposits and disbursements in its Unemployment Insurance Financial Transaction Summary reports for the months of January through June 1989. The department correctly reported the total amounts of deposits and disbursements on the monthly reports. However, the department overstated deposits and disbursements relating to reimbursable employers and understated the amounts relating to all other employers.

State governments, local governments, and nonprofit organizations pay for unemployment insurance for their employees on a reimbursable basis. The department pays the unemployment insurance benefits to qualified ex-employees of these reimbursable employers and then bills the employers for the unemployment insurance benefits paid.

The department reports information relating to reimbursable employers based on activity recorded in the reimbursable employer receivables account. However, when the department makes certain adjustments to the reimbursable employer receivables account, it causes the same deposit and disbursement activity to be recorded twice. The department did not identify and eliminate the duplicate amounts for reimbursable employers before preparing its monthly Unemployment Insurance Financial Transaction Summary reports. Consequently, the department reported incorrect information to the U.S. Department of Labor.

Criteria: The U.S. Department of Labor Manual, Transmittal Letter Number 1441, requires the department to report to the U.S. Department of Labor reimbursable employer information on the Unemployment Insurance Financial Transaction Summary report. The manual requires the official who signs the report to certify that the report is accurate.

Recommendation: The department should modify its method for identifying deposits and disbursements related to reimbursable employers so it can report accurate information to the Department of Labor.

Item 4. **Insufficient Support for Financial Reports of the Job Training Partnership Act Program**

Finding: The department did not sufficiently support the amounts, in its financial reports at June 30, 1989, that the department owed to subgrantees and that the subgrantees owed to the department for the Job Training Partnership Act program. Without sufficient support for these amounts, the department lacks assurance that its financial reports are accurate.

Specifically, the department reported approximately \$236,000 more in amounts owed to subgrantees than the department had recorded in the supporting detail records of its subgrant accounting system (SAS). In

addition, the department reported in its financial reports approximately \$128,000 less in amounts that the subgrantees owed to the department than the department had recorded in the SAS.

The differences exist because the department did not reconcile the amounts in its SAS with the related accounts in the general ledger before preparing its financial reports.

The department reports that it has implemented procedures to regularly reconcile the amounts in its SAS with the general ledger accounts and to make corrections for any differences between the two systems.

Criteria: The Code of Federal Regulations, Title 29, Part 97.20(b)(6), requires the department to maintain accounting records that are supported by source documentation.

Recommendation: The department should reconcile the amounts in its subgrant accounting system with the related accounts in the general ledger to resolve differences between the various accounting records and to ensure that it properly supports its financial reports.

Item 5. Late Resolution of Audit Reports for Subrecipients of the Job Training Partnership Act

Finding: The department did not resolve questioned costs in 22 of 40 audit reports for subrecipients of the Job Training Partnership Act program within the required 180 days of the subrecipient's receipt of the final audit report. Failure to resolve questioned costs can result in additional questioned costs if the subrecipients do not correct deficiencies in their internal controls within a reasonable time.

We reported a similar weakness during our financial audits for the four previous fiscal years. The department reports that, because of limited staffing levels in the past, it was unable to resolve all the questioned costs identified in the audit reports within the required time. The department has since established a unit within its Job Training Partnership Division to resolve the questioned costs in the audit reports for the subrecipients of the Job Training Partnership Act program. In January 1990, the department reported that it had reduced to three the number of audit reports that identify questioned costs for fiscal year 1988-89.

Criteria: The Office of Management and Budget, Circular A-128, requires the department to ensure that subrecipients take appropriate corrective action within 180 days after the department receives their audit reports.

Recommendation: The department should continue its efforts to reduce the delays in the audit resolution process so it can resolve questioned costs in all subrecipients' audit reports within 180 days after the issuance of the reports.

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).

Item 1. Possible Liability to the Federal Government

Finding:

The State has a possible liability to the federal government of up to \$12 million of profits earned by the data center's revolving fund from July 1, 1984, through June 30, 1989. The data center provides data processing, procurement of electronic data processing equipment, and related training services to state agencies. The data center bills these agencies for more than the costs it incurs. In turn, state agencies have passed on to federal programs the charges for the services provided by the data center. When the data center's charges for services exceed its costs, its revolving fund accumulates profits. The California Government Code, Section 11755, allows the data center to accumulate profits in its revolving fund up to certain limits. However, current federal rules prohibit the State from charging federal programs for more than its costs.

In 1984, the federal Department of Health and Human Services (DHSS) audited the State's internal service funds' methods for setting rates. As a result of this 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 July 1, 1969, to June 30, 1984. Of this amount, the State charged approximately \$2.9 million to the data center as the federal share of the data center's profits at June 30, 1984. Based on the Department of Finance analysis, the approximately \$2.9 million represented 57.8 percent of \$5.1 million accumulated profits of the data center at June 30, 1984. From July 1, 1984, through June 30, 1989, the data center's accumulated profits have increased by approximately \$20.5 million, after audit adjustments reducing accumulated profits by \$7.4 million. The State may be liable to repay the federal government for federal amounts in its accumulated profits.

Using procedures similar to those of the Department of Finance, and using the same ratio of 57.8 percent, we estimate that, under current federal regulations, the State may owe the federal government approximately \$12 million. This is the federal share of profits accumulated by the data center during the period July 1, 1984, through June 30, 1989. However, proposed changes to federal regulations may reduce the State's liability to the federal government to approximately \$8 million.

The chief deputy director of the data center advised us that the data center is in agreement that the retained earnings have grown by \$20.5 million. However, she does not agree that the State's potential liability to the federal government may be as high as \$12 million. She stated that retained earnings increased partly because of an increase in the data center's investment in data processing equipment, fees paid from the State's General Fund for management of facilities, and interest earned on the data center's investments.

However, the federal Office of Management and Budget, Circular A-87, provides for the recovery of equipment purchases through depreciation. By using the ratio of 57.8 percent described above, we acknowledge that some of the retained earnings were accumulated from state-funded programs. There may have been a change since 1984 in state agencies and programs served by the data center that could change the ratio of federal participation.

Since 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 data center charges for the period July 1, 1984, through June 30, 1989, charged to federal programs. For the purpose of estimating the possible liability to the federal government, we used the percentage of accumulated profits at June 30, 1984, that the data center refunded to the federal government. This percentage was 57.8 percent.

The potential liability to the federal government exists because the data center does not adjust its billing system sufficiently to prevent it from recovering more than the costs of services it provides. Also, the Department of Finance has not ensured that the State does not charge the federal government more than the State's costs.

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.

In October 1988, the federal Office of Management and Budget proposed amendments to Circular A-87. These proposed amendments would allow the State to retain a reasonable working capital reserve in internal service funds of up to 60 day's cash expenditures, excluding 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 to approximately \$8 million. As of January 16, 1990, the Office of Management and Budget had not approved the proposed amendments to Circular A-87.

Recommendation:

The Department of Finance should ensure that the State complies with federal regulations. This could be done by developing guidelines for the data center and state agencies that receive services from the data center. In addition, the Department of Finance should monitor the proposed amendments to Circular A-87 to determine the effect the revisions may have on the State's charges to federal programs.

Item 2.

Weaknesses in Accounting Procedures

Finding:

The data center has weaknesses in accounting procedures. We noted the following specific deficiencies:

- The data center did not record a liability at June 30, 1989, for overcharges to be refunded to state agencies. As a result, the data center overstated revenues and understated liabilities by \$6.2 million on its year-end financial statements;
- The data center incorrectly recorded four invoices as revenues and due from other funds although the revenues were not earned as of June 30, 1989. As a result, the data center

overstated revenues and due from other funds by \$1.05 million on its year-end financial statements;

- The data center does not reconcile its listing of outstanding invoices with its general ledger control account. In addition, the data center does not reconcile its detail property records and detail listing of installment contracts with the general ledger control accounts. Consequently, it cannot be certain that amounts recorded in the general ledger are correct; and
- The data center did not record a liability of approximately \$108,000 for interest due on installment contracts payable as of June 30, 1989. As a result, the data center understated its interest expense and liability by \$108,000.

As a result of the deficiencies discussed in the preceding paragraphs, the data center's financial reports submitted to the State Controller's Office for preparation of the State's general purpose financial statements are in error.

Criteria:

The State Administrative Manual, Sections 7630, requires the agency to account for amounts due to other funds in its year-end accruals. In addition, the State Administrative Manual, Section 10546, states that revenues earned but not received as of June 30 will be accrued at year end. Finally, the State Administrative Manual, Section 7900, stresses the importance of monthly reconciliations. Reconciliations are an important internal control because they provide an 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 13.714, 13.786, and 13.787.

Item 1. Food Vouchers Not Reconciled Promptly

Finding:

The department was late in reconciling approximately 72 percent of issued food vouchers with food vouchers redeemed in fiscal year 1988-89 for the federal Special Supplemental Food Program for Women, Infants, and Children. Specifically, the department's monthly reconciliations indicate that for fiscal year 1988-89, approximately 17.5 million of 24.3 million food vouchers, or 72 percent, were not reconciled within 150 days of the first valid day for participant use. As of December 31, 1989, the department had not reconciled vouchers for the months of April, May, and June 1989.

Although the department ultimately reconciles all the food vouchers redeemed with the food vouchers issued, failure to promptly reconcile issued food vouchers with redeemed food vouchers may delay detection of irregularities such as redemption of food vouchers that the department did not issue to participants.

Problems with the department's Optical Character Recognition (OCR) system may have contributed to the delays in completing monthly reconciliations. For the last seven months of fiscal year 1988-89, 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 prepare the monthly reconciliations promptly.

We reported a similar weakness during our audit for fiscal year 1987-88. The department responded that it would pursue obtaining faster and more extensive maintenance of its equipment used to develop data on issuance of vouchers and would try to expand the availability of backup services for recording data on issuance of vouchers.

Criteria: Title 7 of the Code of Federal Regulations, Section 246.12(n)(1), requires the department to reconcile issued food vouchers with redeemed food vouchers within 150 days of the first valid date for participant use.

Recommendation: The department should develop procedures to ensure that it reconciles issued food vouchers with redeemed food vouchers within 150 days of the first valid date of participant use.

Item 2. Suspension of Procedures for Detecting and Resolving Dual Enrollment

Finding: In July 1987, the department suspended its use of the reports to detect participants who may enroll in the federal Special Supplemental Food Program for Women, Infants, and Children at more than one location. The system did not operate as intended and produced inaccurate dual enrollment reports.

Through a contract with the Department of General Services, production of dual participation reports has resumed; however, these reports also contain inaccuracies. The department's failure to produce reports to identify dual enrollments reduces the department's ability to detect and resolve participant abuses.

We reported a similar weakness during our audit for fiscal year 1987-88. The department responded that it had identified the problem and that it was working with the Department of General Services to correct the problem.

Criteria: Title 7, of the Code of Federal Regulations, Section 246.12(k)(2), requires the department to establish procedures designed to detect and resolve participant abuses.

Recommendation: The department should continue its efforts to establish reliable procedures to detect dual enrollments.

Item 3. Inaccurate Federal Financial Reports

Finding: The department submitted inconsistent and inaccurate reports to the United States Department of Agriculture for the Special Supplemental Food Program for Women, Infants, and Children (WIC) for

federal fiscal year 1987-88. Specifically, the department reported administrative expenditures of \$28.9 million for the WIC in its financial status report whereas the department's accounting records show that administrative expenditures were \$27.6 million, a difference of \$1.3 million.

In addition, in the WIC Monthly Financial and Program Status Report, the department reported \$28.1 million in administrative expenditures, \$800,000 less than the amount reported on the department's financial status report. The department staff could not reconcile the two amounts. Inaccurate information may adversely affect the federal government's evaluation of the program.

Criteria: Title 7 of the Code of Federal Regulations, Section 246.13(c), requires the department to maintain records that adequately identify the source and use of funds spent for program activities.

Recommendation: The department should establish procedures to ensure that it submits accurate and consistent reports to the federal government.

Item 4. Lack of Evidence of Site Reviews

Finding: At two of the eight local agencies that we tested, the department could not provide evidence that it had conducted required annual site reviews for the administration of the Special Supplemental Food Program for Women, Infants, and Children (WIC). Without such site visits, the department has little assurance that the local agencies are in compliance with requirements of the federal program.

Criteria: Title 7 of the Code of Federal Regulations, Section 246.6(b), states that local agencies providing WIC services should meet the following specific requirements in dispensing services to beneficiaries: (1) have competent professionals on staff; (2) provide appropriate health services; (3) provide nutrition education; (4) implement a prescribed food delivery system; (5) maintain adequate records of accounting; and (6) maintain adequate records of participant certification. 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 maintain adequate documentation of these reviews.

Item 5. Overpayments to Medi-Cal Providers

Finding: The department overpaid Medi-Cal providers for certain claims for office visits by Medi-Cal beneficiaries. The overpayments occurred because of a deficiency in the computer system that processes the claims. The affected claims were "crossover" claims, which are claims for services to beneficiaries eligible for both the federal Medicare program and the state Medi-Cal program. Providers first submit these claims to Medicare, which pays part of the claim. The Medi-Cal program then pays the balance of the claim up to the maximum amount allowed under Medi-Cal. The combined total paid to providers is limited to the maximum amount allowed under Medi-Cal.

However, from at least April 1988 through August 7, 1989, the department's computer systematically calculated overpayments for an undetermined number of crossover claims. These claims had identical Medicare and Medi-Cal procedure codes, and the amount allowed under Medicare was more than the amount allowed under Medi-Cal. Thus, the amount paid to providers for each claim exceeded the amount allowed under Medi-Cal.

Two of the 82 claims that we reviewed were crossover claims that fell into this category. For these two claims, the department overpaid providers \$579. We do not know the complete financial effect of this system error. The department has implemented changes to correct the deficiency in the computer system.

Criteria: The Welfare and Institutions Code, Section 14109.5, limits as much as possible the combined payment for Medicare and Medi-Cal to no more than the amount allowed by Medi-Cal.

Recommendation: The department should ensure that payments for crossover claims do not exceed the amount allowable under the Medi-Cal program. In addition, the department should identify and collect overpayments to providers.

Item 6.

Federal Reimbursements Not Requested

Finding:

The department has not requested 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 75 percent of the costs for personal services, travel, and training and 50 percent of other costs that county CHDP staff incur in serving children eligible for Medi-Cal.

However, because the counties do not separately identify the CHDP costs on invoices, the department did not request reimbursement for any of the reimbursable costs incurred in the nine counties that participated in the CHDP program during fiscal years 1987-88 and 1988-89. Based on cost information that the counties provided, we estimate that costs totaling approximately \$80,000 are federally reimbursable.

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 require counties to indicate separately the costs incurred in providing CHDP services and should request reimbursement for these amounts from the federal government.

Item 7.

Medi-Cal Overpayments Not Credited to the Federal Government on Time

Finding:

The department did not credit the federal government for the federal share of overpayments to Medi-Cal providers within the time specified by the federal government. The department originally overpaid these providers with state funds and with federal funds that the department requested through the federal Medical Assistance Program. Although the department identified over \$24 million in overpayments as of June 30, 1989, the department was 58 days late in fully crediting the federal government for the federal share of the overpayments.

Criteria: Title 42 of the United States Code, Section 1396b(2)(C), requires the State to credit the federal government for the federal share of overpayments within 60 days after identifying the overpayments, whether or not the State has collected the overpayments.

Recommendation: The department should credit the federal government for the federal share of overpayments to providers for the Medi-Cal program within 60 days after identifying the overpayments.

Item 8. Delay in Implementing a System To Avoid Paying Medi-Cal Claims for Beneficiaries Who Have Other Health Care Coverage

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 are liable.

Since May 1986, federal regulations have required the department to have implemented a cost avoidance system to reject and return to 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 the 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. During the first phase, completed in fiscal year 1986-87, the department included in its cost avoidance system Medi-Cal beneficiaries enrolled specifically in prepaid health plans and health maintenance organizations. During Phase II, completed in fiscal year 1988-89, the department expanded the system to include beneficiaries who have other health plans that provide full coverage. The department regards full coverage as coverage that pays for three of the following four services: hospital inpatient, hospital outpatient, physicians, and drugs.

The department is currently implementing Phase III, which will add beneficiaries whose health plans provide partial coverage. In addition, Phase III will address alternatives for providing expanded

health-insurance information to providers. The department expects to complete Phase III in January 1991.

Until Phase III is complete, the department will continue to pay some claims for which third parties may be liable. For example, 6 of the 82 claims that we examined involved Medi-Cal services to beneficiaries who had other health care coverage. In each of the 6 cases, the department paid the claims before it identified the third parties and could return the claims to the providers for collection from appropriate third parties.

The department provides to the federal Health Care Financing Administration a quarterly status report on its progress in implementing a cost avoidance system. In the report for the quarter ending September 1989, the department reported savings of \$6.7 million for that quarter resulting from the cost avoidance system. At that date, the department was using the cost avoidance system for 26 major health insurers.

We reported a similar weakness during our audits for fiscal years 1986-87 and 1987-88.

Criteria: Title 42 of the Code of Federal Regulations, Section 433.139, requires 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. The providers must collect from the third parties 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.

Item 9. Late Approval of Agreements for Primary Care Services for the State Legalization Impact Assistance Grants

Finding: The department's Primary Health Care Systems Branch (branch) did not approve agreements with nonprofit providers of primary care services funded by the federal State Legalization Impact Assistance Grants (SLIAG) until after the nonprofit agencies began

providing services. For the 1987-88 SLIAG grant, we found 35 agreements that the branch approved from two to six months after the end of the fiscal year to which they applied. For the 1988-89 SLIAG grant, we found 75 agreements that the branch approved from one to three months after the end of the fiscal year to which they applied. Moreover, for the 1989-90 grant, the branch is again approving SLIAG agreements after the providers have begun rendering services.

The chief of the department's Rural and Community Health Division cited two main reasons for the department's late approval of agreements with primary care clinics. First, the federal government was late in notifying the department about key funding issues for SLIAG. For example, although the SLIAG program began during state fiscal year 1987-88, the federal government did not issue, until state fiscal year 1988-89, a decision allowing all primary care clinics that serve those eligible for SLIAG to participate in the SLIAG program. The department did not have other key funding issues resolved until it received the first federal SLIAG policy manual, six months after the start of the second fiscal year of the program. In addition, the chief stated that the department's limited staff resources contributed to the delays.

Failure to have agreements properly approved before work begins limits the State's capacity to monitor the work and may leave the State and the providers liable for services that were not rendered in compliance with requirements of the federal grant. Because the department did not pay providers until after the agreements were approved, the providers did not receive reimbursement for services until long after they rendered the services.

Criteria: The federal Office of Management and Budget, Circular A-102, Subpart C, requires federal grant recipients to manage the day-to-day operations of grant and subgrant supported activities. The circular also requires federal grant recipients to monitor grant and subgrant supported activities to ensure compliance with applicable federal requirements and to ensure that performance goals are being achieved.

Recommendation: The department should approve agreements with providers of services before providers render services.

Item 10.

The California Children Services Branch Made Excess Reimbursements to Counties from the State Legalization Impact Assistance Grants

Finding:

The department provided excess reimbursements to certain counties that performed services for the California Children Services Branch (branch). We estimate that, for one claim schedule that we tested, the department provided up to \$38,000 in excess reimbursements from the State Legalization Impact Assistance Grants. These reimbursements represented the full costs claimed by counties for medical services provided to aliens who did not have demonstrated status as eligible legalized aliens (ELA).

The California Children Services Branch directed the counties to document ELA status for costs claimed on invoices by reporting the date of each alien's eligibility for ELA status and by providing the document that supports the date. Despite its instructions to counties, the branch did not always return to counties invoices that did not document these dates. Furthermore, the branch also directed counties to accept an alien's employment authorization card as evidence of ELA status. However, an alien's employment authorization card documents only that the alien has applied for ELA status.

Criteria:

The federal SLIAG Administrative Manual, Module 10, specifies that the cost of public assistance services to applicants is fully and immediately reimbursable only for aliens who have ELA status. The SLIAG Administrative Manual, Module 10, specifies that the cost of public assistance services for aliens who have applied for ELA status is partially reimbursable. The Department of Health Services IRCA/SLIAG Bulletin 89-17, dated December 6, 1989, describes two acceptable methods of claiming these amounts.

Recommendation:

The California Children Services Branch should either require counties to submit only the cost of services provided to aliens who have ELA status or require the counties to submit information that enables the branch to distinguish between services provided to aliens who have ELA status and aliens who have only applied for ELA status. This information will enable the branch to provide accurate reimbursements to counties.

Item 11.

Insufficient Documentation for Expenditures of the Sexually Transmitted Disease Control Portion of the State Legalization Impact Assistance Grants Program

Finding:

The Sexually Transmitted Disease Control Program (program) does not always require sufficient documentation for the program's charges to the State Legalization Impact Assistance Grants. For example, 8 of the 11 invoices that we reviewed did not have sufficient documentation to support the reasonableness of the amounts that participating counties claimed as their actual costs. For these 8 invoices, the program paid between \$13 and \$164 for apparently same or similar services, although the counties' claims provided no information that would justify the different rates. The claims did not provide information on the nature and number of services rendered, the costs of those services, the level of medical personnel rendering the services, or the program income. Each of these factors could affect the amount claimed.

The chief of the Sexually Transmitted Diseases Control Program believes that the program does have sufficient documentation to determine that costs claimed by counties are reasonable for the program. The chief also said that the program requires in its agreements with counties that counties maintain records sufficient for routine complete audits.

Failure to monitor payments from the State Legalization Impact Assistance Grants may leave the State and counties liable for services that were not rendered in compliance with requirements of the federal grant.

Criteria:

Title 45 of the Code of Federal Regulations, Section 74.61(f), requires the State to establish procedures to determine whether costs for the State Legalization Impact Assistance Grants are reasonable, allowable, and allocable. The federal Office of Management and Budget, Circular A-102, Subpart C, requires federal grant recipients to manage the day-to-day operations of grant and subgrant supported activities. The circular also requires federal grant recipients to monitor grant and subgrant supported activities to ensure compliance with applicable federal requirements and to ensure that performance goals are being achieved.

Recommendation: The Sexually Transmitted Disease Control Program should require counties that claim reimbursement from the State Legalization Impact Assistance Grants for services rendered to document the reasonableness of amounts claimed.

Item 12. **Ineffective Cash Management for State Legalization Impact Assistance Grants**

Finding: The department did not have effective cash management procedures for the State Legalization Impact Assistance Grants (SLIAG). For example, the department overdrew approximately \$5.3 million in SLIAG funds for expenditures incurred in the Health Care Deposit Fund. Once the department discovered the error, it transferred \$2.5 million from the Health Care Deposit Fund back to the SLIAG fund. The additional \$3.35 million remained in the Health Care Deposit Fund, and the department charged Medi-Cal expenditures against the overdrawn amount until the overdraw was exhausted, 96 days after its discovery.

In addition, the department did not ensure that federal funds were available before it submitted claim schedules to the State Controller's Office for payment. This weakness occurred because the department did not coordinate the receipt and disbursement of federal funds before submitting claims to the State Controller's Office for payment. The State Controller's Office returned six claim schedules totaling approximately \$2.3 million because of insufficient federal funds in the department's cash accounts. As a result, the department delayed payment of the claim schedules for an average of six days and created additional work for both the State Controller's Office and the department.

Criteria: Circular 1075, Section 205.4, of the federal treasury stipulates that the timing and amount of federal cash advances be as close as administratively feasible to the actual disbursement by the recipient organization. The California Government Code, Section 13401, requires each agency to maintain effective systems of internal accounting and administrative control to minimize error.

Recommendation: The department should ensure that its cash management procedures are adequate to allow the amount and timing of requests for federal funds for

SLIAG claims to be as close as administratively feasible to the actual disbursements.

Item 13. **Failure To Analyze Collections from Health Insurers Promptly**

Finding: The department did not promptly analyze collections from third party health insurers. State regulations require the department to determine if it should distribute to Medi-Cal providers or health insurance policyholders any amounts collected. During fiscal year 1988-89, the department's health insurance unit distributed approximately 5.4 percent of the collections to Medi-Cal providers or health insurance policyholders. However, at June 30, 1989, the department had not yet analyzed approximately \$228,000 that it had collected from health insurers before June 30, 1988.

When the department does not promptly analyze collections from health insurers, it may improperly retain collections that it should distribute to Medi-Cal providers or health insurance policyholders. In addition, the department is unable to maintain accurate records of amounts due from health insurers.

We reported a similar weakness during our audit for fiscal year 1987-88. The department responded that it expected to be current on its analysis of collections from third party health insurers by February 1989. Although the department did not meet this goal, it reduced the amount of unanalyzed collections by approximately \$1.5 million by the end of the fiscal year.

Criteria: Title 22 of the California Code of Regulations, Section 50769, requires the department to distribute certain of the amounts collected to Medi-Cal providers or health insurance policyholders. Generally, the State Administrative Manual, Sections 10401 and 10452, requires agencies to analyze their uncleared collections account and clear the account at least once each month.

Recommendation: The department should promptly analyze its collections and reduce its amounts due from health insurers. In addition, the department should determine if it should distribute to Medi-Cal providers or health insurance policyholders any amounts collected.

Item 14.

Inaccurate Estimate of Receivables

Finding:

The department did not follow generally accepted accounting principles in estimating receivables reported to the State Controller's Office for inclusion in the State's financial statements. The department estimated receivables owed to the Health Care Deposit Fund at June 30, 1989, to be approximately \$249 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, in its financial statements prepared in accordance with generally accepted accounting principles, reports receivables that are expected to be collected within 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, 1989, was higher than it should have been under generally accepted accounting principles.

Our estimate of the receivables that the department would collect in the ensuing 12 months is approximately \$74 million, \$180 million less than the \$254 million that the department estimated. The department overestimated the receivables because it does not maintain records of collections of receivables by the fiscal year in which the department established the receivables.

We reported a similar weakness during our audit for fiscal year 1987-88. The department responded that its accounting unit was developing a historical base that would include subsequent collection of accounts receivable by fiscal year for use in providing an accurate estimate of receivables.

Criteria:

The California Government Code, Section 12460, requires the State Controller's Office to present the State's financial position in accordance with generally accepted accounting principles. Each department must maintain its accounting system in a way that makes this possible so that the State Controller's Office can meet this requirement.

The Governmental Accounting Standards Board prescribes generally accepted accounting principles for state governments. In its Governmental Accounting and Financial Reporting Standards, Section 1100.108, the Governmental Accounting

Standards Board requires states to report receivables that are measurable and available within the ensuing 12 months.

Recommendation: The department should report at year end only receivables that it expects to collect in the ensuing 12 months. In addition, the department should record collections of receivables by the fiscal year that the department established the receivables.

Item 15. **Noncompliance With Certain Federal and State Requirements**

Finding and
Criteria:

We noted the following instances in which the department did not always comply with federal and state administrative requirements.

- The department has not developed procedures to ensure that vendors endorse all food vouchers that it redeems for the federal Special Supplemental Food Program for Women, Infants, and Children. Vendors did not endorse 4 of 72 food vouchers that we examined. Title 7 of the Code of Federal Regulations, Section 246.12(s)(4), requires the department to ensure that it can identify redeemed food vouchers to specific vendors. Section 246.12(e) also states that only authorized vendors may redeem food vouchers. We reported a similar weakness during our audit for fiscal year 1987-88.
- The department paid certain invoices twice. Specifically, we noted an invoice for \$107,990 that the department paid twice. The department did not recover the duplicate payment for 133 days and, as a result, the State lost approximately \$3,418 in interest on that amount. In addition, one of the 47 claim schedules for the department's general fund that we examined included an invoice for \$42 that was paid twice. The State Administrative Manual, Section 8422.1, requires state agencies to determine that payment has not previously been made before submitting an invoice to the State Controller's Office for payment.

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

Recommendation: The department should improve its compliance with federal and state 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. Department of Health and Human Services grants, Federal Catalog Numbers 13.786 and 13.992.

Item 1. Lack of Monitoring of Secondary Recipients' Cash Balances

Finding: The department did not adequately monitor the cash balances of secondary recipients for the ADAMHS federal block grant during fiscal year 1988-89. In the previous fiscal year, the department monitored each secondary recipient's cash balance at the end of each quarter. However, during fiscal year 1988-89, the department did not monitor all secondary recipients' cash balances at the end of each quarter. Of the 19 secondary recipients, the department did not monitor 2 for the first quarter, 11 for the second quarter, and 18 for the third quarter. The department did not monitor any secondary recipients for the fourth quarter of 1988-89. As a result of this lack of monitoring, the secondary recipients may have maintained cash balances that exceeded federal limits. The assistant deputy director of the department informed us that the department did not adequately monitor secondary recipients' cash balances because of the loss of experienced staff.

Criteria: The Code of Federal Regulations, Title 31, Section 205.4(a) and (e), requires that cash advances to a primary recipient organization be limited to the minimum amounts needed and 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. 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. Advances made to secondary recipients are to conform substantially to the same standards of timing and amount as apply to advances by federal agencies to primary recipient organizations. In our opinion, proper compliance with federal requirements 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.

Item 2. No Assessment of the Effectiveness of Secondary Recipients' Performance

Finding: The department did not conduct program reviews of secondary recipients of the ADAMHS federal block grant during fiscal year 1988-89. Such reviews are necessary to assess the effectiveness of the performance of secondary recipients of block grant funds. In fiscal year 1987-88, the department did conduct program reviews of the secondary recipients. The assistant deputy director of the department said that the lack of program reviews during fiscal year 1988-89 is a temporary result of the department's internal reorganization.

Criteria: The Office of Management and Budget, Circular A-110, Section 74.81, mandates that the state Department of Mental Health monitor the performance of secondary recipients.

Recommendation: The department should conduct program reviews of secondary recipients to assess the effectiveness of their performance as required by federal regulations.

Item 3. Delays in Requesting Reimbursements From the Federal Government

Finding: The department does not promptly request reimbursement monthly from the federal government for expenses of administering the ADAMHS federal block grant. We reviewed the reimbursements for these expenses for fiscal year 1988-89 and determined that the department delayed requesting reimbursements for 7 of 12 months and for periods ranging from 6 to 153 days. As a result, the State lost potential interest earnings of approximately \$5,700.

Criteria: Prudent fiscal management and Section 0911.4 of the State Administrative Manual require that the department secure prompt reimbursement from grant funds for goods and services provided.

Recommendation: The department should promptly request reimbursement from the federal government for expenses of administering of the ADAMHS federal block grant.

Item 4. Inadequate Controls Over Property

Finding: The department does not maintain adequate controls over its property. The department has not made a physical inventory of its property in the last three fiscal years. Additionally, in the last three fiscal years, the department has not reconciled its property list with its accounting records. We observed a similar weakness during our financial audit for fiscal year 1987-88. Failure to maintain adequate controls over property may result in an undetected loss of state property.

Criteria: The State Administrative Manual, Section 8650, requires departments to keep records of all capitalized property and related information, and Section 8652 requires departments to make a physical count of all property and reconcile the count with accounting records at least once every three years.

Recommendation: The department should perform a physical inventory of all its property and reconcile the inventory with its accounting records.

Item 5. Inaccurate Identification of Encumbrances

Finding: The accounting personnel of the department did not accurately identify which of its unliquidated encumbrances were payables at June 30, 1989. As a result, approximately \$544,000 of payables were incorrectly classified as outstanding encumbrances. Under generally accepted accounting principles, encumbrances are commitments for goods or services to be received in the future, and accounts payable are commitments for goods or services that have been received. If the department does not properly identify encumbrances, the State Controller's Office does not have sufficient information to prepare the State's financial statements in accordance with generally accepted accounting principles.

Criteria: The State Administrative Manual, Section 7952, requires state agencies to disclose in their financial report the portion of payables that represents encumbrances.

Recommendation: During year-end closing, the department should analyze its accounts payable and encumbrances to determine whether goods were received or services provided before or after June 30, and it should report them appropriately in its financial statements as liabilities or encumbrances.

Item 6. **Inadequate Controls Over Contracts**

Finding: The department does not maintain adequate controls over its contracts. We found the following specific deficiencies:

- The department does not review contractor evaluations before awarding consulting contracts as required. Therefore, the department does not have knowledge of the State's previous experience with a particular consultant contractor and may not be using all available resources when awarding its consulting contracts;
- For six of ten contracts we reviewed, the department had not completed a contractor evaluation within 30 days of the completion of the contract as required. As a result, neither the department nor the Department of General Services (DGS) can be sure that the contractor has satisfactorily completed the contract; and
- For one of ten contracts we reviewed, we found that the contractor began contract work before the DGS approved the contract. Additionally, for two contracts that were exempt from DGS approval, we found that contractors began work before the department approved the contract. Finally, for one contract that was not exempt from DGS approval, we found that contractors began contract work before either the department or the DGS approved the contract. As a result, the State may be liable for work that is not approved.

Criteria: The Public Contract Code, Section 10371(e), requires that no consulting services contractor be awarded a contract unless the department has reviewed a contractor evaluation form on file with the DGS. If the contractor has not had a previous contract with any state entity, a completed resume for each contract participant who will exercise a major administrative role or major policy or consultant

role must be attached to the contract for public record. The Public Contracts Code, Section 10369, requires that a contractor evaluation must be prepared and forwarded to the DGS within 30 days after the completion of every contract. The State Administrative Manual, Section 1209, (formerly Section 1204), requires departments to submit each contract in time for the DGS to approve the contract before work commences. Although two of the contracts discussed in this finding were exempt from the requirement that the DGS approve them, the reasons for requiring approval of a contract before work commences is to ensure that the State is adequately protected by the terms of the contract and that disputes do not arise over work performed without a contract. This same reasoning supports the conclusion that the department should approve contracts before contractors begin work.

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 contracts are properly awarded and completed in the State's best interest.

DEPARTMENT OF REHABILITATION

We issued two reports for the Department of Rehabilitation (department). We reviewed the department's administration of the U.S. Department of Education grant, Federal Catalog Number 84.126 (Items 1-3) and we reviewed the department's internal audit unit (Item 4).

Item 1. Failure To Ensure Compliance With Federal Audit Requirements

Finding: The department failed to properly review independent audit reports of subrecipients submitted in fiscal year 1988-89. The department accepted 18 of the 20 audit reports that we 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. 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 private, nonprofit subrecipients are in compliance with applicable laws and regulations. The Code of Federal Regulations, Title 34, Section 74.61, requires subrecipients to have a financial and compliance audit in accordance with standards of the United States Comptroller General. These standards require a statement of positive assurance on items of compliance that were tested or a statement of negative assurance on items that were not tested.

Recommendation: The department should ensure that audit reports of subrecipients meet federal requirements.

Item 2. Inaccurate Federal Financial Report

Finding: The department inaccurately prepared the financial status report for June 30, 1989, that it submitted to the United States Department of Education. The

department made an error that overstated the federal share of expenditures by approximately \$92,000 and understated the federal share of encumbrances by approximately \$92,000. Specifically, the department incorrectly included approximately \$1.1 million of indirect administrative costs in its direct-cost base. A percentage of the direct-cost base is used to determine the total indirect costs charged to the federal government. As a result, the department overstated the federal share of expenditures and understated the federal share of encumbrances by the same amount.

We reported a similar error during our audit for fiscal year 1987-88. In response, the department stated that it corrected the error on a subsequent financial status report.

Criteria: The Code of Federal Regulations, Title 34, Section 361.24(a), requires the department to maintain accounts and supporting documents for an accurate determination of the financial status of the grant. According to the authorized indirect cost-rate agreement with the United States Department of Education, the department should not include indirect administrative costs in its direct-cost base.

Recommendation: Before the department submits its financial status reports, it should review the calculations used to determine program costs. In addition, the department should correct this error in its next federal financial report.

Item 3. **Noncompliance With Certain Federal and State Requirements**

Findings and Criteria: The department did not always comply with administrative requirements of the federal and state governments. We noted the following instances of noncompliance.

- For 4 of 60 client files that we reviewed, the department did not review the written rehabilitation plan within a year. The Code of Federal Regulations, Title 34, Section 361.40(c), requires the department to review written rehabilitation plans annually.

- For 10 of 60 client files that we reviewed, the department did not document that clients were informed of the assistance available, the review procedures, and the requirements for individual rights and case confidentiality. The Code of Federal Regulations, Title 34, Sections 361.39 and 361.41, and the State Plan require the department to document that clients were informed of the assistance program, the review procedures, and the requirements for individual rights and case confidentiality.
- For one of 60 client files that we reviewed, appropriate department personnel had not signed and dated the certification of eligibility. The Code of Federal Regulations, Title 34, Section 361.35(a), requires the certification of eligibility to be dated and signed by an appropriate department staff member.
- For 8 of 60 client cases we reviewed, the department did not document its determination of the availability of comparable services and benefits under other programs. The Code of Federal Regulations, Title 34, Sections 361.41(a)(9) and 361.47(b), requires that the State determine if comparable services and benefits are available under any other program before it provides any vocational rehabilitation services, excluding specified exceptions.
- The department submitted its indirect cost rate proposal (ICRP) for fiscal year 1988-89 to the United States Department of Education on March 24, 1988, 39 days before the Department of Finance approved it. The State Administrative Manual, Section 8756.1, requires state agencies to send their ICRP to the Fiscal Control Unit of the Department of Finance for review before sending the ICRP to the cognizant federal agency for approval. We reported a similar weakness during our financial audit of the department for fiscal year 1987-88. However, the department had submitted its ICRP for fiscal year 1988-89 before receiving our audit report for fiscal year 1987-88.

Although individually these instances of noncompliance may not appear to be significant, they are deviations from state and federal requirements.

These state and federal requirements 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 and state requirements noted above.

Item 4. The Organizational Placement of the Internal Audit Unit Impairs Its Independence

Finding: The organizational placement of the internal audit unit within the department impairs the unit's independence. Specifically, the unit is organizationally under the deputy director of the Administrative Services Division, who also has authority over the activities of the accounting, personnel, business services, budget and contracts, and electronic data processing (EDP) units that the internal auditors are required to review. For example, the internal auditors are required to review the internal controls associated with accounting and EDP within the department. Nevertheless, both the auditors and staff of the accounting and EDP report to the deputy director of the Administrative Services Division. As a result, the deputy director could influence the scope of the internal audit and its recommendations related to the activities under his supervision.

We reported a similar weakness in our report entitled "The State of California Should Improve Its Internal Audit Capabilities," Report F-499, July 1986. In its response to our report, the department indicated that the chief deputy director of the department has assumed complete authority over internal audits and reports. The department added that the remainder of the unit will continue reporting to the deputy director of the Administrative Services Division for all other audit functions. The department, however, has not updated its administrative manual, which serves as the unit's audit charter, to reflect this change as required by the SPPIA.

As noted above, the department has made improvement in the reporting procedures of the internal audit unit. While this change contributes to greater independence, it still does not fully promote the concept of independence. For example, because the chief of the unit continues to report to the deputy

director of the Administrative Services Division, others may question the unit's independence. Additionally, the deputy director's supervisory duties, which include evaluating the job performance of the chief of the unit, may affect the actions of the unit.

Criteria: The SPPIA, Section 110.01.1, requires that the chief of the internal audit unit be responsible to an individual in the organization with sufficient authority to promote independence and sufficient authority to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations. Further, Section 100.01.4 requires internal audit units to have a formal written audit charter or a similar document that describes the unit's position within the department and shows to whom the unit reports.

Recommendation: The department should place the unit under the authority of either the director or the chief deputy director of the department. In addition, it should revise the unit's audit charter to include a description of the unit's placement within the department and show to whom the unit reports.

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, 10.561, and 10.568 and the U.S. Department of Health and Human Services grants, Federal Catalog Numbers 13.645, 13.658, 13.667, 13.780, 13.783, 13.786, 13.787, and 13.802.

Item 1. Lack of Monitoring of State Supplementary Program Payments

Finding:

The department does not have a quality control function for monitoring federal disbursement of State Supplementary Program (SSP) payments. The State provides supplementary payments to the federal Social Security Administration for aged, blind, or disabled persons who meet the SSP's income and resource requirements. The Social Security Administration determines the eligibility of applicants, computes grants, and disburses monthly payments to the recipients. The State spent over \$1.9 billion on the SSP in fiscal year 1988-89.

The Social Security Administration sends the State monthly magnetic tapes that serve like an invoice showing detailed information on payments and collections. In past years, the department had a quality control function that examined the accuracy of the federal government's review of selected payments. The department's quality control function determined whether payments had been made to ineligible recipients and whether erroneous payments had been made to eligible recipients. Under a "federal fiscal liability" program, the State received reimbursement from the federal government for projected errors based on the error rate determined by these reviews.

However, as of October 1984, the federal government dropped the "federal fiscal liability" program and the department subsequently discontinued its quality control function. According to the chief of the Adult Program Management Bureau, although the Social Security Administration conducts quality assurance reviews on a regional basis, these reviews are used to identify problem areas in the region and not to address state-specific errors. In addition, according to the department's contract with the

federal Department of Health and Human Services, the State has the right to audit the federal administration of the SSP, but the State has not conducted such an audit since 1983. Because the department has no quality control function for monitoring the expenditures, and has not audited the program in recent years, the State does not have sufficient assurance that expenditures of state monies are correct.

Although the department's decision to discontinue its monthly quality control review may have been reasonable from a cost-benefit perspective, in view of the federal government's decision to stop paying for projected errors, the State must still have some level of assurance about the operation of the program. A periodic quality control review would provide such assurance.

Criteria: The California Welfare and Institutions Code, Sections 12152, 12200, and 12201, stipulates requirements for eligibility and payment of aid under the SSP. Good business practice dictates that the State have sufficient assurance that the federal government is operating the program as the State intends.

Recommendation: The department should perform a quality control review periodically to provide assurance that the federal government is operating the program in the manner that the State intends. Because its contract with the federal government calls for the State to sign an annual form releasing the federal government from any liability for errors, the department should perform quality control testing for at least one month each year.

Item 2. **Continued Problems Reconciling Reports That Summarize State Supplementary Program Payments**

Finding: The department continues to have problems in reconciling reports that summarize State Supplementary Program (SSP) payments. This problem in reconciling the summary reports is in addition to the lack of a quality control review described in Item 1. The federal Social Security Administration sends monthly financial accountability statements and supporting Financial Accounting Exchange (FAX) magnetic tapes to the State so that the statements and tapes can be reconciled. The FAX tapes are like invoices in that they include detailed information

on payments and collections. However, the department does not adequately reconcile the FAX tapes with the financial accountability statements.

In our audits of fiscal years 1985-86, 1986-87, and 1987-88, we also reported that the department did not adequately reconcile the FAX tapes with the financial accountability statements. The department has determined that it could not complete the reconciliations primarily because FAX totals that its computer program generated, which are intended to replicate the Social Security Administration's totals, differed from the Social Security Administration's totals.

For fiscal year 1988-89, the department attempted, throughout the year, to reconcile the FAX tapes with the financial accountability statements, using the department-generated FAX totals as it had done in the past. Completing the reconciliations in this manner resulted in a net unresolved difference of approximately \$9.8 million between FAX totals that the department's computer program generated and totals on the Social Security Administration's financial accountability statements. In August 1989, in response to our concerns, the department began to investigate the reconciliation process further. Using the Social Security Administration's totals on the FAX tapes, the department was able to reconcile all months in fiscal year 1988-89 except July and August 1988. The unresolved differences for July and August 1988 totaled approximately \$3.3 million.

Although the department has made progress in understanding the reconciliation process, the reconciliations that the department completed for fiscal year 1988-89 are still not sufficient. The department is reconciling totals generated by the Social Security Administration on the FAX tapes with totals generated by the Social Security Administration on the financial accountability statements without verifying independently how the totals generated by the Social Security Administration on the FAX tapes are summarized. Further, despite significant unresolved differences in the July and August 1988 reports, the department signed away, in May 1989, its right to collect on errors for October 1987 through September 1988. In August 1989, the department requested that its data-processing personnel review its computer program for processing the FAX tape.

Criteria: The State Administrative Manual, Section 8422.1, discusses verifying the accuracy of price extensions and totals on invoices. Also, 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 adequately recorded and that financial records are complete.

Recommendation: The department should review its computer program and rewrite it, if necessary, so that the State can independently verify the totals generated by the Social Security Administration on the FAX tapes. Further, the department should reconcile the financial accountability statements with the FAX tapes, using the totals generated by the department's computer program. Finally, the department should not sign a release form that precludes it from collecting monies for errors in periods for which it has not reconciled the reports.

Item 3. Lack of Request for Federal Reimbursement

Finding: The department did not request approximately \$2.2 million in federal reimbursement for amounts it spent during fiscal year 1988-89 for the State Supplementary Program (SSP). As discussed in Item 1, the State provides supplementary payments to the federal Social Security Administration for the SSP. The Social Security Administration administers the program and disburses monthly payments to recipients. A portion of the SSP payments are made to persons who obtain resident status under the Immigration Reform and Control Act of 1986. The State can obtain reimbursement for these payments through the federal State Legalization Impact Assistance Grants (SLIAG) program.

Although the department had monthly reports showing that it had spent approximately \$2.2 million during the fiscal year for SSP payments to SLIAG recipients, accounting personnel did not receive copies of these reports and, thus, did not realize that a portion of the SSP payments the department made was eligible for reimbursement through the SLIAG program. Consequently, accounting personnel inappropriately charged these payments to the State instead of recording them as federally reimbursable expenditures.

After we brought this matter to its attention, the department recovered federal reimbursement of approximately \$1.5 million of the \$2.2 million on December 8, 1989. However, the department's delay resulted in the State's losing approximately \$137,000 in interest earnings as of December 1, 1989. Further, the department must obtain a budget revision before requesting reimbursement for the remaining amount.

Criteria: The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from grant funds for goods and services provided. Also, the California Government Code, Section 13401, requires each agency to maintain effective systems of internal accounting and administrative control to minimize error.

Recommendation: The department should request the remaining reimbursement of approximately \$700,000 from the federal government. Further, the department should ensure that its accounting personnel receive all the information that they need to properly account for the department's financial operations.

Item 4. 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 \$322,000 in potential interest income and was unable to promptly honor all claims. We reported similar weaknesses in each of our audits for the past four years.

We tested the department's cash management of 87 local assistance expenditure transactions. Of the 87 transactions, the department did not disburse 39 within a reasonable period before or after the date that the department received the federal funds. We generally considered a 5-day period as reasonable. Of the 39 transactions, 29 were transactions for which the department did not promptly request federal funds, and 2 were transactions for which the department requested federal funds in excess of its immediate needs. Additionally, the department did not reimburse the State's General Fund promptly for 8 transactions because department documentation indicated that the department used available grant monies for other reasons. 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. We tested 19 transactions for this program. Allowing the department five 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 7 to 38 days late in requesting reimbursement for all 19 of the transactions we tested. As a result, the State lost approximately \$156,000 in interest income.

- The department did not promptly request federal funds to reimburse the State for expenditures funded by the Foster Care--Title IV-E program, the Child Welfare Services--State Grants program, the Family Support Payments to States--Assistance Payments program, the Work Incentive Program, and the Refugee and Entrant Assistance--State Administered Programs. We tested 28 transactions for these programs. Allowing the department five days to request and receive reimbursement, the department was 5 to 288 days late in requesting reimbursement for 7 of the 28 transactions we tested. As a result, the State lost approximately \$144,000 in interest income.

- The department did not promptly request federal funds to reimburse the State for expenditures relating to the Work Incentive Program and the Family Support Payments to States--Assistance Payments program. We examined all four payments made to the Employment Development Department for contracts related to these programs. Allowing the department five days to request and receive reimbursement, the department was 84 days late in requesting a federal reimbursement of approximately \$249,000 for one expenditure. As a result, the State lost approximately \$5,000 in interest income.

- The department requested federal funds for reimbursement in excess of the department's immediate needs because the department did not ensure that state spending authority, necessary for disbursing federal funds, was sufficient before it submitted claim schedules to the State Controller's Office for payments to counties. In September 1988, the State Controller's Office returned two claim schedules totaling approximately \$1.2 million in federal funds because of insufficient state spending authority in the department's Federal Trust Fund. At that time, the department requested and received federal reimbursement from the Family Support Payments to States--Assistance Payments program for the two returned claim schedules. The department did not submit the budget revision to increase spending authority to the Department of Finance until May 1989 and did not receive approval of the budget revision until July 1989. The department did not resubmit the claim schedules for payment until September 1989. As a result, the department delayed payments to counties for almost 360 days. Additionally, because the department did not use the federal funds to pay other claims and did not return the funds to the federal government, the department maintained excess federal funds for that same period.

- The department did not promptly reimburse its general fund for federally reimbursable expenditures that it incurred for the State Supplementary Program. At the beginning of each month, the department advances money from its general fund to the federal government to administer the State Supplementary Program. Approximately \$900,000 of this monthly advance is reimbursable from the Refugee and Entrant Assistance--State Administered Programs grant. We reviewed the department's advances for the 17 months from February 1988 through June 1989. The department did not reimburse its general fund for the eight months of February through September 1988 until October 1988. As a result, its general fund was not reimbursed for these months until 36 to 248 days after the general fund incurred the expense. Department documentation indicated that the general fund was not reimbursed

promptly because sufficient grant funds were not available to pay all projected costs of the program for that period, and the department placed a higher priority on disbursing monies to the local governments. However, due to the nature of the data, we did not verify estimates that the department used in making its decision. Additionally, for two other months, the department did not request federal funds promptly, although grant funds were available. As a result of the delay in requesting funds for the two months, the State lost approximately \$17,000 in interest income.

We did not find problems with the department's cash management system for 10 local assistance contract expenditures and 7 Child Support Incentive expenditures that we tested.

Criteria: The State Administrative Manual, Section 0911.4, requires state agencies to secure prompt reimbursement from grant funds for goods and services provided. Circular 1075, Section 205.4 of the federal Department of Treasury stipulates that the timing and amount of federal cash advances be as close as administratively feasible to the actual disbursement by the recipient organization.

Recommendation: The department should promptly request federal funds only in amounts that the department immediately needs.

Item 5. Improper Cash Management for the Social Security--Disability Insurance Program

Finding: The department requested federal funds in excess of the department's needs. For support expenditures such as those of the Social Security--Disability Insurance program, the department requests a monthly advance from the federal government to fund the amount of expenditures that it estimated that it incurred during the month. According to the department's records, during the first six months of fiscal year 1988-89, the department obtained federal funds and advanced the funds to its general fund in excess of actual expenditures for the Social Security--Disability Insurance program. The following table shows monthly expenditures and monthly excess advance balances for the program for the first six months of the fiscal year:

EXPENDITURES AND BALANCE OF EXCESS ADVANCE:
SOCIAL SECURITY-DISABILITY INSURANCE PROGRAM
JULY-DECEMBER 1988

<u>Month</u>	<u>Expenditures</u>	<u>Balance of Excess Advance</u>
July	\$9.7 million	\$2.0 million
August	\$7.2 million	\$4.0 million
September	\$7.2 million	\$3.7 million
October	\$7.5 million	\$3.6 million
November	\$8.2 million	\$4.2 million
December	\$7.5 million	\$3.9 million

The department reduced the amount of excess advance during the last six months of the fiscal year. The department's records indicate that the average monthly excess advance during the last six months was approximately \$279,000, while average monthly expenditures were \$7.1 million. According to a department accounting administrator, this condition occurred in the first six months because requests for federal funds were not reduced by the amount of the excess advance that occurred in the previous month. Requesting federal funds in excess of the department's needs may result in termination of advance financing by the federal government.

Criteria: Circular 1075, Section 205.4 of the federal Department of Treasury stipulates that the timing and amount of federal cash advances be as close as administratively feasible to the actual disbursement by the recipient organization.

Recommendation: The department should request federal funds only in amounts that the department immediately needs.

Item 6. Questionable Charges to Federal Programs

The department made charges for personnel time to federal programs during fiscal year 1988-89 that were questionable. The department based the charges on methodologies that used information not current or on methodologies that did not appear to equitably allocate costs between federal and state funds. We observed questionable charges for personnel time in three areas:

- The Community Care Licensing Division charged approximately \$926,000 to the Foster Care-- Title IV-E program based on a methodology using a workload study performed in February 1986. Additionally, the division did not use current statistics when calculating amounts based on its methodology. Because the division did not base its charges on a current workload study and did not use current statistics when calculating amounts, the division's allocation of costs may not be equitable based on current conditions.

- The Disability Evaluation Division charged approximately \$11.5 million to the Social Security--Disability Insurance program using percentages based on a time study performed in one week during March 1988. That time study determined the average number of cases involving both state and federal issues that clerical staff handled in each district office. The division then used this information to compute the percentage of clerical time that should be charged to state funds. Because the division reported few cases involving both state and federal issues compared to the total cases during the week of the time study, the division calculated that it should charge only approximately 0.3 percent of personnel time to state funds and should charge the remaining 99.7 percent to federal funds. However, because the division based its charges on a time study conducted for a short period and because the time study was not updated periodically, the department cannot demonstrate that it has equitably allocated costs between federal and state funds.

- The Aid to Families With Dependent Children Policy Bureau charged approximately \$296,000 to the Family Support Payments to States-- Assistance Payments program and approximately \$16,400 to the State Legislative Impact Assistance Grants program during fiscal year 1988-89 based on a methodology in which employees submit narratives of items worked on during the month. In a summary narrative, the bureau identified the funding source for each item. The bureau then allocated the total labor charges based on the number of times a particular funding source appeared on a summary narrative compared with the total of the items

worked on for the bureau. Because the bureau based its charges on a methodology that treated each item worked on as taking an equal amount of time and could not show that each of the items took an equal amount of time, the department cannot demonstrate that it has equitably allocated costs between federal and state funds.

Criteria: Circular A-87 of the federal Office of Management and Budget 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 produce an equitable distribution of time and effort.

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

Item 7. Federal Financial Reports Not Reconciled With the Accounting Records

Finding: The department did not reconcile federal financial reports prepared during fiscal year 1988-89 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 and 1987-88. In past years, the department responded that it was seeking a redirection of staff to implement the reconciliation process. During fiscal year 1988-89, the department did perform partial reconciliations of prior quarters for some of the programs. Specifically, the department performed a partial reconciliation on prior quarter expenditure reports for the Family Support Payments to States-- Assistance Payments program, the Food Stamps program, and the Foster Care--Title IV-E program. The department did not prepare any reconciliation for the Child Support Enforcement program, the Child

Welfare Services--State Grants program, the State Legalization Impact Assistance program, and the Refugee and Entrant Assistance--State Administered Programs.

Criteria: Circular A-102, Subpart C, of the federal 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 ensure that federal reports are reconciled with the department's official accounting records.

Item 8. **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 the 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 \$147,000 in indirect costs to the TEFAP in fiscal year 1988-89.

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 only if they would otherwise be allowable as state-level storage and distribution costs.

Further, United States Department of Agriculture correspondences dated March 29, 1984, and December 21, 1988, 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.

Item 9.

Inappropriate Loan Using Federal Funds

The department inappropriately used approximately \$15.9 million of federal funds to pay a portion of the State's share of estimated expenditures for the State's Aid to Families with Dependent Children (AFDC) program. Further, the department did not have its general fund reimburse its Federal Trust Fund for the \$15.9 million for 70 days. When the department uses federal funds to pay for state expenditures, the funds are not available for expenditures that are eligible for federal reimbursement as intended by the federal government.

In June 1989, the State's General Fund loaned the department approximately \$15.9 million so that the department could advance monies to the counties for the AFDC program. According to an accounting administrator, the department requested the loan from the State's General Fund because there was insufficient budget authority in the department's general fund. On July 5, 1989, the department obtained \$15.9 million from the federal Family Support Payments to States--Assistance Payments program. However, the department used this money to repay the loan from the State's General Fund, although the loan had been for advancing to counties the State's share of the AFDC program. The accounting administrator stated that the department reasoned that because the department's general fund had incurred expenditures on behalf of the Federal Trust Fund for expenditures relating to the federal Foster Care--Title IV-E program resulting in a shortage in the State's appropriation that funds AFDC and Foster Care, the Federal Trust Fund could

pay the general fund share of AFDC expenditures until the department's general fund recovered some of the Foster Care--Title IV-E funds. At that time, the general fund would repay the Federal Trust Fund for AFDC.

The department received federal money for the Foster Care--Title IV-E program on July 26, 1989. The department then attempted to repay the department's general fund the \$15.9 million at that time so that the general fund could repay the loan from the federal Family Support Payments to States--Assistance Payments program. However, because of insufficient spending authority, the department was unable to complete the transaction. After the Department of Finance approved the necessary budget revisions, the State Controller's Office increased the department's spending authority on September 5, 1989. The department subsequently repaid the loan on September 14, 1989, 70 days after the department had initially used the federal monies.

Criteria: The Code of Federal Regulations, Title 45, Section 74.170, states that grant funds may be used only for allowable costs of the activities for which the grant was awarded.

Recommendation: The department should request federal funds only for the federal share of expenditures and should not use federal funds to loan money to its general fund.

Item 10. **Inappropriate Use of a Letter of Credit to Pay Expenditures Funded Under Another Letter of Credit**

Finding: The department used funds drawn from one letter of credit to pay for expenditures of programs funded by a different letter of credit. Specifically, the department used \$1.06 million of funds drawn from the letter of credit that funds the Social Security--Disability Insurance program to pay estimated expenditures of \$425,000 for the Child Support Enforcement program and to pay estimated expenditures of \$635,000 for the Family Support Payments to States--Assistance Payments program. The Child Support Enforcement program and the Family Support Payments to States--Assistance Payments program are funded by a different letter of credit from the Social Security--Disability Insurance program. The department did not obtain the funds from the Child Support Enforcement program and the

Family Support Payments to States--Assistance Payments program to repay the Social Security--Disability Insurance program until 313 days later (after we brought this matter to the staff's attention.) In addition, the department obtained \$5,000 from the Social Security--Disability Insurance program on September 30, 1988, to pay expenditures of the Child Support Enforcement program. The department did not repay the Social Security--Disability Insurance program until approximately a year later. When funds are used from one letter of credit to pay for expenditures funded by a different letter of credit, the funds may not be available for the expenditures for which the funds were intended.

Criteria: The Department of Health and Human Services Manual for Recipients Financed under the Payment Management System, Section 203.2(A4), stipulates that cash drawn for certain programs and not disbursed should be used for other programs funded by the same letter of credit.

Recommendation: The department should use funds drawn from a letter of credit to pay only expenditures of programs funded by that letter of credit.

Item 11. Lack of Support for Use of Federal Funds Held for Five Years

Finding: The department held approximately \$484,000 in unidentified federal receipts for approximately five years. These funds were moved from the Social Welfare Federal Fund to the Federal Trust Fund when the Social Welfare Federal Fund was abolished in 1984. The department did not return these funds to the federal government but rather transferred the funds, in June 1989, to pay expenditures for the Refugee and Entrant Assistance--State Administered Programs grant. The department had no conclusive documentation that the federal funds were received for that program. As a result, the department cannot demonstrate that it appropriately used the funds. Additionally, maintaining excess federal funds over long periods may result in termination of advance financing by the federal government.

Criteria: Circular A-102, Subpart C, of the federal Office of Management and Budget requires that grantees maintain records that adequately identify the source and application of funds provided for financially-

assisted activities. Additionally, Circular 1075, Section 205.4, of the federal Department of Treasury stipulates that the timing and amount of federal cash advances be as close as administratively feasible to the actual disbursement by the recipient organization.

Recommendation: The department should maintain records that adequately identify the source of funds received from the federal government. Additionally, if the department cannot identify federal funds that it has received, it should return the funds to the federal government rather than hold the funds for long periods.

Item 12. 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 Social Security Disability Insurance program, the Child Welfare Services program, the Family Support Payments to States-- Assistance Payments program, and the Refugee and Entrant Assistance--State Administered Programs.

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 disbursed. As a result, the department did not report any excess federal funds on hand in the fiscal year 1988-89 cash reports that we tested, although department records indicate cash on hand for each of the programs.

The only excess federal funds that the department included on the quarterly reports for one of the letters of credit is for approximately \$3.7 million originating before 1983. The federal government preprints this same amount on every federal cash transaction report for the letter of credit that includes the Foster Care-Title IV-E program, the Social Security--Disability Insurance program, the Child Welfare Services program, and the Refugee and Entrant Assistance--State Administered Programs. The federal government continues to show this same amount on the quarterly reports until the department

can document that it spent the funds. When we inquired, the department could not provide documents to support the expenditures.

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 grantees' 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.

Item 13. Lack of Documentation of Monitoring and Evaluating the Foster Care Program

Finding: The department was unable to provide documentation that it monitored and evaluated activities carried out for the Foster Care--Title IV-E program. Although the department could provide evidence that it notified counties that a site visit was to take place, the department did not document evaluation procedures or results. As a result, we were unable to conclude that the department is fulfilling federal requirements for monitoring and evaluating the Foster Care program.

According to a manager for the Foster Care Program Bureau, Foster Care program personnel took over fulfilling the monitoring and evaluating requirements from the Quality Control unit in July 1988. Since July 1988, the Foster Care program personnel have been developing their own monitoring and evaluating procedures. According to another manager in the Foster Care Program Bureau, Foster Care program personnel began making initial monitoring visits to counties in December 1988 as part of the process of developing a new monitoring and evaluation system. We observed that, beginning in August 1989, Foster Care program personnel began documenting procedures conducted, persons contacted, and conclusions determined for monitoring and evaluating activities in order to provide adequate evidence that the department is fulfilling the monitoring and evaluating requirements.

Criteria: The United States Code, Title 42, Section 671(a).7, requires the department to monitor and evaluate activities carried out for the Foster Care Title IV-E program.

Recommendation: The department should continue to implement its new system for conducting and documenting monitoring and evaluating procedures.

Item 14. **Noncompliance With Reporting Requirements for Refugee/Entrant Unaccompanied Minor**

Finding: The department's Refugee Program Policy and Systems Bureau (bureau) did not always comply with federal requirements to track and report on unaccompanied refugee minors. Of the ten reports that we reviewed regarding the placement of minors, counties submitted eight more than 30 days after the minor's placement in the State. As a result, the department was unable to submit these reports to the federal government promptly. Of the eight reports, two were due in fiscal year 1988-89. The remaining six were due during 1982 to 1986. We reported the late submission of placement reports for previous years in fiscal year 1987-88. Further, of the six case files that we reviewed for which progress reports were due by December 1989, four did not contain the required annual progress report.

We reported a similar finding in fiscal year 1987-88. The department responded that it would send additional instructions to counties regarding the prompt submission of reports. Additionally, the department responded that it would expand its computer tracking system to ensure that counties submit progress reports. The bureau expanded its computer tracking system and requested the counties to promptly submit the required reports.

Criteria: The Code of Federal Regulations, Title 45, Section 400.120, requires the State to submit to the federal Office of Refugee Resettlement an initial placement report within 30 days of the minor's placement in the State and a progress report every 12 months beginning 12 months from the date of the initial placement report.

Recommendation: The department should continue its effort to ensure that counties promptly submit the required reports so that the department can comply with the federal reporting requirements for tracking and reporting unaccompanied minors.

Item 15.

Delays in Collecting Disallowed Costs or Adjusting for Incorrectly Claimed Costs

Finding:

The department did not promptly collect disallowed costs or adjust for incorrectly claimed 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 records of county welfare departments. While conducting these audits, the State Controller's Office is responsible for determining whether the 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.

Of the 12 audits that we reviewed at November 16, 1989, the department had submitted 2 to the accounting unit so that funds could be recovered from the counties. The department had not yet sent 10 to the accounting unit because the audits were 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. As of November 16, 1989, the department had not collected disallowed costs or adjusted for incorrectly claimed costs for any of the 12 audits that we reviewed. After allowing time for the department to resolve any audit protest or appeal, the delay for the 12 test items had ranged from 386 days to 1,421 days as of November 16, 1989. For the 12 test items, the amount of disallowed costs or incorrectly claimed costs totaled approximately \$863,000.

We reported similar weaknesses in our audits for fiscal years 1985-86, 1986-87, and 1987-88. The department responded to our audit for fiscal year 1987-88 that it would review each audit application to assess the level of difficulty and would establish a plan for each audit application to monitor and complete the work. The department established a backlog list and selected five of the audits for priority processing. However, we saw no documentation that an assessment of the level of

difficulty or a plan for completing all of the audits had been prepared.

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. Good business practice dictates that the State promptly collect money owed to it.

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.

Item 16. **Lack of Proper Authorization for Certain Transportation Expenditures**

Finding: The department did not ensure that vendor invoices for expenditures for rental cars or airline travel were properly authorized or supported. According to the department's records, the department spent approximately \$175,000 on rental car expenses and approximately \$526,000 on airline expenses during fiscal year 1988-89.

Four of the 27 claim schedules for operating expenses that we reviewed included payments for the use of rental cars. We observed that none of the 4 had evidence of department authorization and none had documentation that the department had compared the invoices to the rental agreements. An accounting administrator confirmed that, although the customers' copies of rental agreements and airline tickets were being submitted to the department, the department did not match them to the invoices received from the rental agency or the air travel vendors for most of fiscal year 1988-89. The oldest unmatched rental agreement that we examined was dated December 1986. The oldest unmatched passenger airline ticket we examined was dated November 1987. As a result of not ensuring that such expenditures are properly authorized or supported, the department cannot ensure that all amounts it paid were valid expenditures.

After we discussed this item with the department in May 1989, we observed that the department began matching airline invoices that had accumulated

during fiscal year 1988-89 to the appropriate airline tickets. In addition, the department approved new air travel procedures in July 1989 that require department approval on air travel invoices received from the vendor.

Criteria: The State Administrative Manual, Section 8422.116, requires state agencies to compare the customer's copy of automobile rental contracts with automobile rental invoices to determine the propriety of the charge. Additionally, Section 8422.115 requires state agencies to compare the passenger's copy of airline tickets to the airline invoices to determine the propriety of the charge. Further, Section 8711.3 states that a state agency's accounting office is responsible for verifying invoices from transportation companies to determine that the transportation service was furnished and that the rate charged is correct. Finally, Section 8422.1 states that the department will determine that invoices comply with contracts, service agreements, and similar documents, and that authority existed to obtain the goods or services.

Recommendation: The department should ensure that invoices scheduled for payment have proper supporting documentation and authorization.

Item 17. 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 \$386,000 in services, five did not comply with provisions of the Public Contract Code.

Five of the contracts were not approved by the department before the contractor began work. Additionally, the department could not provide documentation that it had requested an evaluation form from the Department of General Services or that it had reviewed an evaluation form for one consulting contractor who had previously provided services for the State.

Further, the department did not prepare an evaluation for one of four contracts requiring an evaluation until approximately one-and-a-half months after the due date.

Criteria: The Public Contract Code, Sections 10295, 10335, and 10360, states that identified contracts are of no effect unless and until approved by the Department of General Services. Two of the contracts we discuss in this item were exempt from approval by the Department of General Services. However, since state law deems it necessary for the Department of General Services to approve a contract before work begins, we conclude the department should also approve contracts before work begins. In addition, Section 10371 requires that the department review contractor evaluation forms on file with the Department of General Services for contractors who have previously contracted with the State. Also, Sections 10347(a) and 10369 require each state agency to conduct, within 30 days of completion of a contract, an evaluation of each contract awarded.

Recommendation: The department should follow the requirements of the Public Contract Code in establishing and maintaining contracts with vendors.

Item 18. **Noncompliance With Certain State and Departmental Requirements**

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

- We reviewed the department's monthly reconciliations with records of the State Controller's Office for six appropriations for a period of ten months. Of the 60 appropriation reconciliations that we reviewed, the department prepared 36 of them from 3 to 164 days late. The State Administrative Manual, Section 7900, requires agencies to prepare reconciliations monthly within 30 days of the preceding month.
- Of 48 invoices that we reviewed, the department did not submit 5 invoices for payment to the State Controller's Office by the date required. After receiving the 5 invoices, the department held them for 52, 56, 60, 81 and 1,008 days, respectively, before sending them to the State Controller's Office. The Government Code, Section 926.15, requires that state agencies, to avoid a penalty, make payments within 30 days of the required payment

date to small businesses or nonprofit organizations that are awarded contracts. The Government Code, Section 926.17, requires that submission of invoices to the State Controller's Office for payments made to other businesses awarded a contract with a state agency be made within 35 days after the postmark date of the invoice.

- The department did not ensure that counties promptly submit claims for public assistance and administrative costs. For fiscal year 1988-89, 38 of 58 counties were late in submitting 1,246 of 6,242 claims for public assistance costs, and 44 of 58 counties were late in submitting 86 of 180 claims for administrative costs. In a letter to county welfare directors dated October 21, 1987, the department stated that claims for public assistance costs would be due 20 calendar days after the end of the month for which the costs are claimed; the department states that claims for administrative costs would be due 30 calendar days after the end of the quarter for which the costs are claimed.
- The department did not ensure that counties promptly submitted Food Stamp program reports to the department. Of the 116 Status of Claims Against Households reports that we examined, counties did not promptly submit 50 to the department: 41 reports were 1 to 10 days late, 6 reports were 11 to 20 days late, and 3 reports were 43 to 73 days late. The department's Fiscal Management and Control Manual, Section 25-1020, requires counties to submit Status of Claims Against Households reports to the department within 30 days after the end of each quarter.
- The department did not ensure that counties promptly submitted other Food Stamp program reports to the department. Of the 181 Food Coupon Accountability reports that we reviewed, counties submitted 24 reports 1 to 10 days late. Additionally, of the 100 Food Stamp Mail Issuance reports that we reviewed, counties did not submit 10 promptly to the department: 8 reports were 1 to 10 days late, and 2 reports were 11 to 22 days late. Finally, of the 66 Food Stamp Program Reconciliation reports that we reviewed, counties did not submit 8

reports promptly: six reports were one to 10 days late, one report was 15 days late, and one report was 63 days late. The department's Fiscal Management and Control Manual, Section 25-1030, requires counties to submit to the department a Food Coupon Accountability report within 45 days of the end of the month. Additionally, Section 25-1040 requires counties to submit to the department a Food Stamp Mail Issuance report within 45 days of the end of the quarter. Finally, Section 25-1010 requires counties to submit to the department a Food Stamp Program Reconciliation report within 60 days of the end of the month. According to a manager in the Fiscal Policy and Procedures Bureau, the department has granted an informal extension for Los Angeles County of up to 85 days.

- When preparing estimates of liabilities for its financial statements, the department could not provide supporting documentation for amounts that it estimated as owed to local governments for prior year appropriations. Of the amounts that we reviewed, the department could not support \$15 million recorded in its general fund and \$10.2 million recorded in the Federal Trust Fund. 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. Good management practice dictates that estimates be supported by appropriate documentation.

- The department's Welfare Payments unit records all amounts that a fund owes, or is owed, as an increase or decrease to "Due to Local Governments" although some of the amounts are owed to or from another of the department's funds. As a result, on its general fund financial statements, the department reported \$58.9 million as decreases to "Due to Local Governments" although the amounts were owed from the Federal Trust Fund. The department recorded \$15.9 million as increases to "Due to Local Governments" although the amounts were owed to the Federal Trust Fund. Similarly, on its Federal Trust Fund financial statements, the department recorded the corresponding amounts owed to and from the general fund as increases and decreases to "Due to Local

Governments." The State Administrative Manual, Sections 7620 and 7630, defines how amounts due from or to other funds should be classified.

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 improve its compliance with each of the state and departmental requirements.

Item 19.

Noncompliance With Certain Federal Requirements

Finding and
Criteria:

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

- The Accounting and Systems Bureau charged approximately \$900 to the Refugee and Entrant Assistance--State Administered Programs program instead of the State Legalization Impact Assistance Grants program because staff summarized 42 hours of personnel time under an incorrect reporting code. Circular A-87 of the federal Office of Management and Budget requires that amounts charged to grant programs for personal services be supported by appropriate documentation.
- On one of the 19 invoices that we tested that support payments made by the Disability Evaluation Division (division), the division did not document that it had reviewed the invoice or authorized the services to be performed for that invoice. On another invoice, the division did not document that it had authorized the services to be performed. The department charged to the federal Social Security--Disability Insurance program both payments for which it could not document that it had performed certain procedures. The federal Office of Management and Budget's Circular A-102, Subpart C, requires the department to maintain accounting records that are supported by source documentation.

- The department submitted two quarterly reports of obligations for the Social Security--Disability Insurance program to the federal government two to three days late. The federal Program Operations Manual for Disability Insurance, Section 806.815, requires the State to submit the quarterly report of obligations so that the Social Security Administration central office receives the report no later than the 25th day after the close of the quarter.
- On one of its quarterly report of obligations for the Social Security--Disability Insurance program for fiscal year 1988-89, the department incorrectly classified as costs related to the fiscal year 1988-89 grant award approximately \$6,000 of indirect labor charges that related to the fiscal year 1987-88 grant award. Additionally, on the same report, the department could not provide support for an adjustment of approximately \$29,000 made to unliquidated obligations. The federal Program Operations Manual for Disability Insurance, Section 806.818, requires the State to report all indirect costs that the State has charged to the program for costs incurred during the period covered by the report. Further, Section 806.200(b) states that the State will be responsible for securing necessary data from appropriate sources and for certifying the validity of all data.
- The department did not include approximately \$95,000 in State Legalization Impact Assistance Grant expenditures for August and September 1988 on the federal financial status report for October 1, 1987, through September 30, 1988. Additionally, the department inappropriately included approximately \$1,200 of expenditures for October 1988. The Code of Federal Regulations, Title 45, Section 402.51, requires states to provide the amount expended during the fiscal year ended September 30 on the annual status report.
- The department submitted a report to the federal government for the Family Support Payments to States--Assistance Payments program that does not agree with the supporting documentation for the report. For six of eight

items that we tested, the total number of errors that the department reported on the "AFDC Quality Control Summary Tables" report for the period October 1987 through September 1988 differs from the total number of errors listed on the supporting documentation. The differences range from one to six. According to the chief of the Quality Control Branch, the differences occurred because the database that is the source of the supporting documentation we reviewed reflects necessary changes made subsequent to the date that the department prepared the federal report. The Code of Federal Regulations, Title 45, 205.40, requires that states submit quality control data and reports that the federal government requests. One of the reports that the department submits is the annual "AFDC Quality Control Summary Tables" report.

- The department was unable to provide written authorization for using alternate procedures in preparing and submitting quarterly statements of expenditures for the federal Family Support Payments to States--Assistance Payments program for fiscal year 1988-89. To meet reporting deadlines, the department's new procedure is to submit reports that include estimated data 30 and 60 days after the end of the quarter. The department does not submit reports that include all actual data until 90 days after the end of the quarter. Further, the department was 13 days late and 2 days late by its own procedures in submitting its 90-day report for the first and fourth quarters. The Code of Federal Regulations, Title 45, Section 201.5(a), states that quarterly reports are due 30 days after the reporting period. Section 201.5(a) does not indicate that the reports can include estimated data.

- The department was from 26 to 31 days late in submitting quarterly statements of expenditures for the federal Foster Care--Title IV-E program for the first three quarters of fiscal year 1988-89. Although the department submitted a report for the final quarter within the required deadline, the report did not include actual expenditures because the department had implemented the estimated reporting procedure described in the preceding paragraph. The department could not provide written

authorization to do this for the Foster Care--Title IV-E program either. Federal reporting instructions from the Administration for Children, Youth, and Families state that quarterly reports are due 30 days after the reporting period. The federal reporting instructions do not indicate that the reports can include estimated data.

- The department submitted only the first page of the two-page quarterly statements of expenditures for the Foster Care--Title IV-E program during fiscal year 1988-89. In July 1986, the department submitted a letter to the federal government stating that the required statistical information was not available, and, therefore, the department would not submit information requested on the second page. However, the department was unable to provide documentation that the federal government had approved not submitting this information. Federal reporting instructions from the Administration for Children, Youth, and Families stipulate the information to be included on the quarterly statements of expenditures.
- The department did not submit Food Stamp reports promptly to the United States Department of Agriculture. The department submitted 18 days late its final Financial Status Report for the Food Stamp program for October 1987 through September 1988. Also, the department submitted its last revision to the report 35 days later. Additionally, of the four quarterly financial status reports that we reviewed, the department submitted one report one day late. Further, of the two quarterly Status of Claims Against Households reports that we reviewed for the Food Stamp program, the department submitted a final version of one of the reports 47 days late. The department submitted an initial report that contained information for all but two counties by the required date. Finally, of the 66 county Food Stamp Program Reconciliation reports that we reviewed, according to department records, the department submitted one report one day late and another report 35 days late. For the report that was 35 days late, the county had submitted the report late to the department. The department submitted it to the federal

government 2 days after receiving it. The Code of Federal Regulations, Title 7, Section 277.11, states that the final financial status report is due within within 90 days of the end of the federal fiscal year reported upon. Additionally, Section 277.11 states that the quarterly financial status reports are due within 30 days of the quarter reported upon. Further, the United States Department of Agriculture, in a letter dated October 31, 1984, stated that the Status of Claims Against Households reports are due within 50 days of the end of each calendar quarter. Finally, the Code of Federal Regulations, Title 7, Section 274.8, states that the Food Stamp Program Reconciliation report is due within 90 days of the end of the report month.

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.

Item 1. Delay in Disbursing Federal Grant Monies

Finding: The office's cash management system does not minimize the amount of time between the receipt of federal Disaster Assistance funds and the disbursement to applicants. For 17 of the 29 requests for funds that we reviewed, the State held the federal funds 6 to 55 days before disbursement to applicants. The average number of days between receipt and disbursement for these 17 requests for funds was 14.9 days. Some of this delay can be attributed to the time it takes the State Controller's Office to process the disbursements. The office is aware of the delay in disbursing grant funds to applicants and has implemented new procedures in fiscal year 1989-90 to minimize the delay.

Criteria: Treasury Circular 1075, 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 with its efforts to implement procedures that will minimize the time elapsed between receipt of federal funds and disbursement to applicants.

Item 2. 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 that are to be refunded to the FEMA. When applicants send the refunds to the office, the office remits the refunds to the FEMA. For 10 of the 27 refunds we reviewed, the office took 22 to 67 days to remit the refunds to the FEMA. For these 10 refunds, the average number of days between the receipt of funds from the applicants and remittance to the FEMA was 38.3 days. According to the office, the increase in

disaster relief activity and personnel shortages caused the delay in returning these refunds to the FEMA.

Criteria: The Code of Federal Regulations, Title 44, Section 205.120, 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 disaster applicants upon receipt of these refunds.

Recommendation: The office should promptly remit refunds from applicants to the FEMA.

Item 3. Late Federal Financial Status Reports

Finding: All five of the final financial status reports that the office submitted to the FEMA during fiscal year 1988-89 were from approximately one to three years late. The office prepared and submitted these reports to the FEMA, in March 1989, after it discovered that it had not prepared financial status reports for five disaster grants closed in previous fiscal years.

Criteria: The federal Office of Management and Budget, Circular A-102, Paragraph 884A, requires that a final financial status report be completed and submitted within 90 days following completion of the grant.

Recommendation: The office should complete and submit final financial status reports within 90 days following closure of disaster grants.

Item 4. Inaccurate Federal Financial Status Report

Finding: The financial status report that the office submitted to the FEMA for the 1983 Coalinga earthquake disaster was inaccurate. Specifically, the office erroneously reduced total local assistance expenditures for the amount of a \$246,000 refund to the FEMA. As a result, the office understated total expenditures on the financial status report by the \$246,000.

Criteria: The California Government Code, Section 13401, requires each state agency to maintain effective systems of internal accounting and administrative control as an integral part of its management

practices. The federal Office of Management and Budget, Circular A-128, defines internal control as the plan of organization and methods and procedures adopted by management to ensure that reliable data are obtained, maintained, and fairly disclosed in reports.

Recommendation: The office should ensure that federal financial reports it submits to the federal government are accurate.

Item 5. **Noncompliance with Certain Other Federal Requirements**

Finding and Criteria: We noted the following instances where the office did not always comply with the administrative requirements of the federal government:

- For fiscal year 1988-89, the office submitted two federal cash transaction reports to the FEMA one and three days late, respectively. The federal Office of Management and Budget, Circular A-102, Paragraph 883Q, requires that federal cash transaction reports be completed and submitted within 15 working days following the end of each month.
- The office submitted one final financial status report to the FEMA two days late for fiscal year 1988-89. The federal Office of Management and Budget, Circular A-102, Paragraph 884A, requires that a final financial status report be completed and submitted within 90 days following completion of the grant.

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

Recommendation: The office should improve its compliance with federal requirements.

BOARD OF EQUALIZATION

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

Item 1. **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, 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. Further, the board has no contractual agreement with another facility for offsite backup equipment. A major shutdown of the board's EDP system 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 audit of the board for fiscal year 1987-88. Since then, the board has completed a Disaster Recovery Plan and a Feasibility Study Report to resolve this problem. However, the Feasibility Study Report concludes that access to backup hardware for the board's EDP system is not anticipated until fiscal year 1990-91 at the earliest.

To resolve this weakness, the board proposed a change to its budget for fiscal year 1990-91. However, in October 1989, the Department of Finance rejected this request.

Criteria: The State Administrative Manual, Section 4909.8, which was in effect during fiscal year 1988-89, required departments that have critical EDP systems involving the collection of income to ensure that backup procedures are in place. These backup procedures would include 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.

Item 2.

Erroneous Tax Area Codes Are Not Promptly Revised

Finding:

The board does not always promptly revise tax area codes of registered businesses when revisions are necessary. As a result, the board cannot ensure that it promptly distributes the correct amount of sales and use taxes to each local government.

The board's district offices manually assign a tax area code to a business upon registration. The tax area code is used to determine the amount of sales and use taxes that the board is required to distribute to units of local governments such as cities, counties, and transit districts. Tax area codes are revised when businesses relocate, when city or county boundaries change, or when coding errors occur.

As a follow up on the manual assignment process, staff in the Local Tax Unit (LTU) review the assigned tax codes to ensure that staff at the field offices make necessary revisions. However, in our review of 60 registration cards with tax area code errors already identified by the board's staff, we found that the district offices had not corrected the errors they identified on 22 cards.

We reported a similar weakness during our financial audits of the board for fiscal years 1985-86, 1986-87, and 1987-88. In response, a board official stated that procedures have now been revised so that the LTU normally makes the necessary revisions to the tax area codes. Since the board may not have implemented this change until late in the fiscal year, the effect of the change may not be evident until our next audit cycle.

In addition, in response to our previous audits, the LTU requested in March 1988 that the board's Information Management Division automate the process of assigning tax area codes. As of December 1989, the board's LTU had purchased a personal computer system and had begun in-house programming to sort current registration data as an interim automation process. A board official estimates that the completion time for this project is six to nine months. In addition, the official stated that the board is rewriting the programs for its mainframe registration process to allow the interim enhancements to be part of the mainframe system. The rewrite is expected to take two to three years.

Finally, the LTU is working with the board's property tax division to acquire a geographical information system to be used on the board's mainframe computer. This system would give the board the ability to assign tax area codes based on street address. The board official stated that its completion will depend on the availability of systems, technology, and funding.

Criteria: The California Government Code, Section 13403, states that elements of a satisfactory system of internal accounting and administrative control shall include a system of recordkeeping that is adequate to provide effective accounting control over assets, liabilities, revenues, and expenditures. In addition, the contracts between the board and the local governments require the board to distribute to these jurisdictions, as promptly as feasible, the amounts to which they are entitled.

Recommendation: The board should continue to work towards automating its assignment of tax area codes.

Item 3. Deficient Contracting Procedures

Finding: The board did not always follow good contracting procedures. Specifically, four of the ten service contracts we reviewed were not approved by the board before the contractor began work. In addition, one of these four contracts was not approved by the Department of General Services before the contractor began work. Finally, for another four of the ten contracts we reviewed, the Invitation for Bids did not identify for potential bidders the criteria the board would use in selecting the winning bid.

If a contractor begins work before the contract is approved, the State may be liable for work that is not approved. In addition, if selection criteria is not included in the Invitation for Bids, all bidders may not be sufficiently informed of the criteria used to select the winning bid.

Criteria: The State Administrative Manual, Section 1204, which was in effect during fiscal year 1988-89, required departments to submit each contract in time for the Department of General Services (DGS) to approve the contract before work commenced. The State Administrative Manual, Section 1209, which replaced this section in fiscal year 1989-90, contains

identical requirements. Although three of the contracts under discussion in this finding were exempt from the DGS' approval, the rationale for DGS' approving a contract before work commences supports the conclusion that the board should approve contracts before the contractor begins work.

The State Administrative Manual, Section 1210, required Invitations for Bids to contain the criteria that will be used in selecting the winning bidder. This section was in effect during fiscal year 1988-89.

Recommendation: The board should ensure that contracts are approved before the contractor begins work. In addition, the board should include a statement in its Invitation for Bids that explains the criteria that the board will use in awarding the contract.

DEPARTMENT OF JUSTICE

We reviewed the internal audit unit of the Department of Justice (department).

Item 1. The Organizational Placement of the Internal Audit Unit Impairs Its Independence

Finding: The organizational placement of the internal audit unit within the department impairs the unit's independence. Specifically, the unit is organizationally under the deputy director of the Administrative Services Division, who also has authority over the activities of accounting, budget, personnel, contract/purchasing, electronic data processing (EDP), and other support units that the internal auditors are required to review. For example, the internal auditors are required to review the internal controls associated with accounting and EDP within the department. Nevertheless, both the internal auditors and the staff of accounting and EDP report to the deputy director of the Administrative Services Division. As a result, the deputy director could influence the scope of the internal audit and its recommendations related to the activities under her supervision.

We reported a similar weakness in our report entitled "The State of California Should Improve Its Internal Audit Capabilities," Report F-499, July 1986. In its response to our report, the department indicated that it planned "to implement an audit review committee which would have responsibility for functional supervision of the internal audit program." However, during our review of the unit for fiscal year 1988-89, the department could not provide an audit charter or other documentation as required by the SPPIA to show the responsibility and authority of the audit committee or approval of such an arrangement by the attorney general.

Because the unit continues to report to the deputy director of the Administrative Services Division, others may question the unit's independence. Additionally, the deputy director's supervisory duties, which include evaluating the job performance of the chief of the unit, may affect the actions of the unit.

Criteria: The SPPIA, Section 110.01.1, requires that the chief of the unit be responsible to an individual in the organization with sufficient authority to promote independence and sufficient authority to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations. Further, Section 110.01.4 requires internal audit units to have a formal written audit charter or a similar document that describes the unit's position within the department.

Recommendation: The department should place the unit under the authority of either the attorney general or the chief deputy attorney general of the department. It should also revise its internal audit charter to include a description of the unit's placement within the department organization and show to whom the audit unit reports.

STATE CONTROLLER'S OFFICE

We reviewed the financial operations and related internal controls of the State Controller's Office and its administration of the U.S. Department of Agriculture grant, Federal Catalog Number 10.665 and the U.S. Department of the Interior grant, Federal Catalog Number 15.999.

Item

Noncompliance With Certain State Requirements

Findings and Criteria:

We noted the following instances where the State Controller's Office did not always comply with state administrative requirements.

- The State Controller's Office did not promptly reconcile the monthly total amount transferred from state agencies to the State Payroll Revolving Fund with the total amount disbursed from the fund. Although the State Controller's Office reconciled these amounts sooner than it did in fiscal year 1987-88, it did not complete the reconciliations until between 3 and 11 months after the close of the business months during fiscal year 1988-89. The State Administrative Manual, Section 7900, requires these reconciliations to be performed monthly within 30 days after the close of the business month.
- The Division of Accounting of the State Controller's Office does not follow up with proper collection procedures for accounts receivables related to replacement warrants issued. We found four instances of inadequate follow-up on this type of receivable. Monies involved in these instances of inadequate follow-up totaled \$1,030. The State Administrative Manual, Section 8710.1, requires state agencies to develop collection procedures that will assure prompt follow-up on receivables.

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 State Controller's Office should improve its compliance with the state requirements noted above.

RESOURCES

DEPARTMENT OF FORESTRY AND FIRE PROTECTION

We reviewed the Department of Forestry and Fire Protection's (department) administration of the U.S. Department of Agriculture grant, Federal Catalog Number 98.016.

Item 1. Lack of Documentation To Support Costs Billed to the Federal Government

Finding: The department could not provide documentation to support all of the costs that it billed the Forest Service of the U.S. Department of Agriculture (U.S. Forest Service) for fire-fighting services. Specifically, for 5 of the 44 billings that we reviewed, the department could not provide documentation to support costs totaling approximately \$158,600. As a result, we cannot determine if the department should have billed the U.S. Forest Service for these costs. Failure to maintain documentation to support the costs that the department bills to federal agencies for fire-fighting services may result in those federal agencies' disallowing such costs.

Criteria: The cooperative fire protection agreement between the department and the U.S. Forest Service requires the department to document all expenditures incurred in providing fire-fighting services.

Recommendation: The department should maintain all documentation that supports costs billed to the federal agencies for fire-fighting services.

Item 2. Late Billings to the Federal Government for Reimbursement of Costs of Fire-Fighting Services

Finding: The department did not promptly bill federal agencies for reimbursement of costs that it incurred providing fire-fighting services on federal lands. For 25 of the 44 billings that we reviewed, the department billed federal agencies from 3 days to 7 months after the required due dates. As a result of the delays, the State lost potential interest earnings of approximately \$192,800.

Criteria: The cooperative fire protection agreements between the department and the U.S. Department of Agriculture and the U.S. Department of the Interior

require the department to submit a bill for reimbursement as soon as possible, but no later than 120 days after the fire is controlled. In addition, the agreements require the department to issue a final billing within 150 days after the fire is controlled. The State Administrative Manual, Section 8099, requires state agencies to request prompt reimbursement for goods and services provided to the federal government to maximize interest earnings.

Recommendation: The department should bill federal agencies for fire-fighting service costs within the periods established in the cooperative fire protection agreements.

Item 3. Incorrect Indirect Cost Recovery Rates

Finding: In reviewing 12 billings for fire-fighting expenditures from July through November 1988, we found that the department used the 5.98 percent indirect cost recovery (overhead) rate for fiscal year 1987-88 instead of the 10.98 percent fire cost recovery rate for fiscal year 1988-89. The overhead rate is added to the direct expenditures for providing fire-fighting services to recover the department's administrative costs. The department used the 5.68 percent rate because the overhead rate of 10.98 percent for fiscal year 1988-89 was not approved until November 1988. However, because the U.S. Forest Service approved the 10.98 percent rate for the entire 1988-89 fiscal year, the department should have recalculated the billings from July through November 1988 using the 10.98 percent rate.

Also, for two charges for aircraft costs, one billed for services in fiscal year 1987-88 and the other billed for services in fiscal year 1988-89, the department incorrectly used a 5 percent overhead rate. The department should have used the approved overhead rates for fiscal years 1987-88 and 1988-89 of 5.68 percent and 10.98 percent, respectively, because the 5 percent rate applied only to the U.S. Forest Service's billings to the State for aircraft charges and not to the department's billings to the U.S. Forest Service for aircraft charges.

Because the department did not recalculate the billings from July through November 1988 using the 10.98 percent rate and because the department did

not use the appropriate overhead rate for aircraft charges, the department failed to recover overhead costs of at least \$9,000.

Criteria: A memo from the U.S. Forest Service, dated November 22, 1988, authorized the department to charge a 10.98 percent fire cost recovery rate in fiscal year 1988-89 to recover administrative costs for providing fire-fighting services.

Recommendation: The department should use the approved fire cost recovery rate applicable to each fiscal year to recover its administrative costs.

Item 4. Unreimbursed Costs of Fire-Fighting Services

Finding: The department did not bill federal agencies for reimbursement of all of the costs that it incurred providing fire-fighting services on federal lands. Specifically, for the costs of one of the 44 fires that we reviewed, the department did not bill for costs totaling \$8,662. The department accumulated these costs with an apparent intent to include them on a billing to the U.S. Forest Service but did not do so, either through oversight or clerical error. Also, for the costs of another fire that we reviewed, the department did not bill for costs totaling \$2,268. These costs might have been for services that are not reimbursable. However, the department could not determine if this was the case. As a result of not billing for all costs of fighting these two fires, the department may have failed to recover fire-fighting service costs totaling \$10,930.

Criteria: The California Government Code, Section 13403, requires agencies to ensure that a satisfactory system of 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 review all costs that it incurred providing fire-fighting services on federal lands to ensure that it identifies and receives reimbursement for those costs.

Item 5. **Activity Cost Reports Not Properly Approved**

Finding: The department did not have proper approvals for all of its activity cost reports (reports) that support billings to federal agencies for reimbursement of fire-fighting service costs. Twelve of the 36 reports that we reviewed lacked the required approvals. In addition, an inappropriate unit within the department prepared 4 of the 12 reports. If the report does not contain all of the proper approvals or the appropriate unit does not prepare the report, the department lacks assurance that the report accurately reflects the cost of providing fire-fighting services. As a result, the department could undercharge or overcharge federal agencies for the cost of providing such services.

Criteria: The department's Fire Information Reporting System Handbook requires that activity cost reports be prepared at a ranger unit and signed by the preparer and the activity supervisor. The department's accounting unit must then review and certify the activity cost reports.

Recommendation: The department should require that the appropriate unit prepares the activity cost report and that the activity cost report has all of the required signatures of approval before it bills a federal agency.

Item 6. **Late Submission of the Indirect Cost Recovery Rate Proposals**

Finding: The department submitted its indirect cost rate proposals (ICRP) for fiscal year 1987-88 in late January 1987, one month after the ICRP was due. In addition, the department submitted its ICRP for fiscal year 1988-89 in May 1988, five months after it was due. The federal government then did not approve the ICRP for these fiscal years until December 1987 and August 1988, respectively. Late approval of ICRPs causes a delay in the department's applying the approved indirect cost rates for that fiscal year, which may result in inappropriate recoveries of indirect costs.

Criteria: The federal Office of Management and Budget, Circular A-87, requires the State to prepare a plan for the allocation of joint and indirect cost related to grant programs. The State Administrative Manual, Section 8756.1, requires state agencies to

submit their indirect cost proposal plans to the responsible federal agency at least six months before the start of the fiscal year to which the plan applies.

Recommendation: The department should submit its indirect cost proposal plans to the appropriate federal agency at least six months before the start of the fiscal year to which the plan applies.

DEPARTMENT OF PARKS AND RECREATION

We reviewed the internal audit unit of the Department of Parks and Recreation (department).

**Item 1. The Organizational Placement of the Audit Unit
Impairs Its Independence**

Finding: The organizational placement of the internal audit unit within the department impairs the unit's independence. Specifically, the unit is organizationally under two deputy directors who both have separate and distinct authority over the different divisions, programs, and activities of the department that the auditors are required to review. For example, the auditors are required to review the internal controls associated with the accounting and electronic data processing (EDP) units within the department. However, both the auditors and staff of accounting and EDP report to the deputy director of the division of administration. Likewise, the auditors are required to review programs and activities relating to planning and local assistance as well as development, acquisitions, and concessions divisions; however, all of these divisions and the auditors also report to another deputy director of the department. Because the unit as a whole reports to two deputy directors of the department, either director could influence the unit's internal audit scope and audit recommendations related to activities under each director's supervision. If the unit is not independent of the areas that it audits, less assurance exists that the audits are conducted in an impartial and unbiased manner. In addition, external auditors cannot rely on the work of the unit and, therefore, may duplicate the work of the internal auditors.

Criteria: The SPPIA, Section 110.01.1, requires that the chief of the unit be responsible to an individual in the organization with sufficient authority to promote independence and sufficient authority to ensure broad audit coverage, adequate consideration of reports, and appropriate action on audit recommendations.

Recommendation: The department should place the entire unit under the direct authority of the director of the department.

Item 2. Incomplete Audit Charter

Finding: The unit's charter does not completely describe the unit's position within the department. Specifically, the charter does not describe the unit's placement within the department nor show to whom the unit reports.

Criteria: The SPPIA, Section 110.01.4, requires internal audit units to have a formal written audit charter or a similar document that describes the unit's position within the department and shows to whom the unit reports.

Recommendation: The department should revise the unit's audit charter to include a description of the unit's placement within the department and show to whom the unit reports.

Item 3. Insufficient Quality Control Procedures

Finding: The unit's quality control procedures do not ensure that the unit's work is planned and managed in accordance with the SPPIA. For instance, in our review of three audits that the unit performed, we found that the unit did not prepare work schedules indicating the activities to be audited, the audit start and completion dates, and the estimated total audit hours. In addition, the unit did not prepare progress reports to show budgeted and actual hours and time variances. We also observed that the unit neither prepares nor submits to management activity reports highlighting significant findings or issues.

Failure to properly plan and manage the audit through work schedules and progress reports can result in inefficient use of audit resources. In addition, without periodic activity reports, the department cannot be assured of a permanent record of audit communications to management officials. Moreover, management is not assured that appropriate action has been taken on significant findings or issues needing its attention.

Criteria: The SPPIA, Section 520, requires the unit to establish plans to carry out its responsibilities as an internal auditing unit. The planning process includes establishing goals and developing audit work schedules, staffing plans, financial budgets, and activity reports.

Recommendation: The unit should establish and implement effective quality control procedures to ensure that audits are properly planned and managed.

DEPARTMENT OF WATER RESOURCES

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

<u>Item</u>	<u>Weaknesses in Accounting Procedures</u>
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Finding:	The department has weaknesses in accounting procedures. We noted the following specific deficiencies:
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- The department does not properly record dispositions of equipment. A one-month delay exists between the time the department records the dispositions in its equipment accounting system and the time it records the dispositions in its general ledger. As a result of the delay, the department overstated the equipment account by approximately \$157,000 and overstated the accumulated depreciation by approximately \$126,000 for the fiscal year ended June 30, 1989.
- The department incorrectly calculated the depreciation expense for 28 of the 31 acquisitions that we reviewed. For the 28 acquisitions, the department used incorrect acquisition dates, incorrect purchase prices, or it incorrectly recorded the equipment data when calculating the depreciation expense. As a result, the department understated depreciation expense and accumulated depreciation by about \$35,000 for the fiscal year ended June 30, 1989.
- The department did not promptly record an equipment acquisition. The department received equipment on June 23, 1989, but did not record the acquisition until fiscal year 1989-90. Consequently, the equipment account and accounts payable balance at June 30, 1989, were understated by approximately \$115,000.
- The department did not reconcile mobile equipment costs on its Depreciation Balances Report and Service Maintenance Equipment List with the related general ledger accounts for the fiscal year ended June 30, 1989. As of June 30, 1989, the cost of mobile equipment shown on the Depreciation Balances Report and

Service Maintenance Equipment List was about \$215,000 more than the amount in the general ledger account. This amount represents the net effect of several reconciling items. For example, at June 30, 1989, the department had recorded two equipment items, totaling approximately \$392,000, in the general ledger but not in the Depreciation Balances Report. As a result of not reconciling the Depreciation Balances Report with the general ledger accounts, the department understated depreciation expense and accumulated depreciation, for these two equipment items, by approximately \$16,200 for the fiscal year ended June 30, 1989.

- The department improperly recorded approximately \$400,000 as accounts payable and expenditures that represented goods or services that had not been received by the fiscal year ended June 30, 1989. Failure to analyze and report payables accurately to the State Controller's Office reduces the ability of the State Controller's Office to prepare the State's financial statements accurately.

We reported several of these weaknesses during our audits for the past three fiscal years. As a result of our previous audit recommendations, the department stated that it was preparing a feasibility study report that supports the update and refinement of its accounting and business related systems. The department stated that it expects to complete the report by the end of fiscal year 1989-90.

Criteria:

The State Administrative Manual, Section 8616, states that agencies should calculate depreciation based on an asset's actual cost or other basis, less the estimated residual value, distributed over the life of the equipment. The State Administrative Manual, Section 8621, requires agencies to remove equipment from their records when they dispose of the equipment. The State Administrative Manual, Section 10544, requires agencies to analyze their obligations at June 30 and to determine whether they received the goods and services before or after June 30. The State Administrative Manual, Section 7900, discusses the importance of making regular reconciliations. In addition, the Department of Water Resources Accounting Manual, Section 6348.8, states that the department should

use the Depreciation Balances Report to reconcile balances reported in the equipment accounting system with the general ledger accounts.

Recommendation: The department should improve its compliance with each of the state and departmental requirements.

STATE AND CONSUMER SERVICES

FRANCHISE TAX BOARD

We reviewed the financial operations and related internal controls at the Franchise Tax Board (board).

Item 1. Insufficient Resolution of Identified Weaknesses in the Bank and Corporation Tax System

Finding: The board has not sufficiently resolved identified weaknesses in the system that it uses to assess, collect, and refund bank and corporation taxes. As a result of the weaknesses, some taxpayers did not receive tax refunds, and other taxpayers did not receive a recalculation of interest to which they were entitled. The weaknesses were identified in a draft report by the board's internal audit unit. In response to the draft audit report, the board assembled a study team that analyzed the weaknesses and recommended policy, system, and procedure changes to resolve them. Although the draft audit report was issued 11 months ago and although the study team completed its five-month study five months ago, the draft audit report has not yet been finalized. Moreover, the study team's final report and approved recommendations did not sufficiently address all identified weaknesses that resulted in some taxpayers' not receiving refunds of overpaid taxes. In addition, the study team's recommendations did not identify time frames to correct the weaknesses that it did address.

A credit balance is created when the board's automated bank and corporation tax system identifies potential overpayments of tax on a taxpayer's file. 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 that informs taxpayers that the board believes the taxpayer owes additional tax. The taxpayer's payment is then 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, the portion of the "deposit" if any, due to the taxpayer, including accrued interest, is either refunded to the taxpayer or used by the board to

offset any amount of tax due. To resolve the credit balances on the board's file of tax overpayments, the board must "examine or in some way review" the taxpayer's account and process internal documents so that, if appropriate, the credit balances can be refunded to the taxpayers.

Since 1951, statutes in the Revenue and Taxation Code have stated that when the board finds that there has been an overpayment of tax for any reason, the board must credit the overpayment against any tax due from the taxpayer and refund the balance. The board's chief legal counsel interprets the word "find" to mean that, for these statutes to apply, the board must "examine or in some way review" a taxpayer's account.

According to the board's senior legal counsel, "Corporate taxpayers are required by law to maintain adequate books and records showing payments made to the board and to compute their tax liability according to state law. Therefore, there is no affirmative legal requirement that the board review taxpayer accounts or refund amounts for which the taxpayer has filed no claim." Therefore, the board does not believe it is legally required under current law to refund credit balances shown on its automated bank and corporation tax system unless it first "examines or in some way reviews" the taxpayers' accounts.

However, if the board does not "examine or in some way review" the taxpayers' accounts before the statute of limitations expires, refunds will not be initiated by the board. The statute of limitations states that the board cannot make refunds after four years from the original or extended due date of the taxpayer's return, or one year from the date of the overpayment, whichever is later, unless the statute is extended by written action of the taxpayer. However, if the board discovers that a credit balance was deleted from the file of tax overpayments in error, the credit balance can be reestablished on the file if the statute of limitations has not expired.

We reviewed the 11-month old draft audit report, the study team's final report, and management's approved recommendations of the study team's alternatives. We identified the following areas that the study team's report did not sufficiently address or that management's approved recommendations of the

alternatives presented by the study team did not sufficiently resolve:

- The board sometimes did not refund credit balances in its automated tax system before the statute of limitations expired. The board also erroneously deleted credit balances before the statute of limitations expired. The board did not refund credit balances before the statute of limitations expired because of two primary problems. First, the board considers "examining or in some way reviewing" the taxpayer accounts listed on the file of credit balances a low priority. Second, a flaw in the automated tax system used to monitor the age of the credit balances did not allow the board to identify the credit balances that should be refunded before the statute of limitations expired. As a result, it did not process the internal documents necessary to generate the refunds to taxpayers. For example, because the board did not "examine or in some way review" credit balances for four corporations before the statute of limitations expired and because there was no evidence that these corporate taxpayers had requested refunds, the board deleted \$52,000 in credit balances, excluding accrued interest, that it potentially owed to these taxpayers.

Moreover, the board processed internal documents that erroneously deleted credit balances from the file of tax overpayments before the statute of limitations expired. By deleting the credit balances, the board erased them from its file of tax overpayments and essentially eliminated the opportunity for taxpayers to receive these amounts as refunds unless the taxpayer requests a refund before the statute of limitations expires. For example, based upon a sample of taxpayer files, the internal auditors identified six taxpayers with credit balances that totaled approximately \$975,000, excluding accrued interest, that the board deleted even though, in some cases, the taxpayers' protests had not been resolved and, in other cases, the statute of limitations had not expired. The study team indicated that most of these errors can be corrected, but others cannot be corrected because the statute of limitations has already expired. However, the study team's report did not outline any

plan to identify all of the taxpayers who had credit balances deleted and who may still be within the statute of limitations. These credit balances could be reestablished on the board's file of tax overpayments and be refunded to the taxpayers, if appropriate, after examination or review.

Because the board did not process internal documents to refund credit balances before the statute of limitations expired and because it erroneously deleted credit balances, the board deleted credit balances that totaled more than \$5.3 million in the last three fiscal years. While some of these credit balances may have been properly deleted, the board will be unable to reestablish the credit balances that it erroneously deleted for those taxpayers for whom the statute of limitations has expired. Also, by deleting credit balances before the statute of limitations expires, the board did not comply with applicable statutes in the Revenue and Taxation Code that required some of these credit balances to be refunded to taxpayers. Further, during that same period, the board reestablished more than \$1.5 million in credit balances that were previously deleted. However, the study team report did not outline a plan to identify the taxpayers that did not receive refunds they were entitled to receive or that taxpayers could have received if the board had "examined or in some way reviewed" their accounts before the statute of limitations expired.

Further, because the board's automated tax system does not calculate the accrued interest on credit balances, the portion of the \$5.3 million in credit balances that should have been refunded to taxpayers is substantially understated because that amount does not include interest. For example, the internal auditors determined that on April 13, 1989, the board deleted a credit balance of \$29,175 that should have been refunded to the taxpayer. If interest had been accrued to the statute of limitations date, it would have amounted to more than \$17,400. Therefore, this taxpayer lost a refund of more than \$46,000.

- The study team report did not sufficiently resolve the internal auditor's concerns related to the implementation of the Avon court decision. According to the draft audit report, 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. The Avon decision defines the balance upon which interest should be paid so that a taxpayer is only charged interest for the period when amounts are due and unpaid. A September 9, 1985, memorandum approved by the board's chief legal counsel stated that to implement this decision, the board should manually correct taxpayers' accounts where potentially large refunds might be made or where the taxpayer requests a recomputation of interest until the necessary changes could be made to the automated bank and corporation tax system.

The study team report stated that, in March 1986, the board's executive management wrote and approved new procedures to implement this decision. However, the report further stated that the procedures were not fully implemented and, therefore, only the taxpayers that requested a recalculation of interest received it. The draft audit report concluded that, based upon a sample of taxpayer files, the board's delay in fully implementing the Avon decision resulted in an overassessment of taxes for certain taxpayers. For example, three taxpayers were overassessed more than \$530,000. Since the statute of limitations had not expired for two of these taxpayers, the board has refunded or is in the process of refunding most of this amount. However, the board may not be able to refund approximately \$59,000 of this \$530,000 because the statute of limitations for making this refund has expired. However, the board may be able to make this refund if it can determine that the taxpayer, in writing, extended the statute of limitations. The study team report concluded that the board should implement procedures to comply with the Avon decision. However, the study team report did not propose that the board perform an analysis to determine whether taxpayers who did not receive the benefit of the Avon decision may still do so before the statute of limitations expires;

- The study team's report, which included recommendations approved by the board's executive staff, allows certain policy decisions under which some taxpayers are not automatically credited with all the interest that they may be entitled to receive through a recalculation of interest. In some instances, some taxpayers may be assessed additional interest. The study team reported that, before March 1980, the board reopened segments of a taxpayer's "income year" so that all segments of the income year could be used in computing interest if a subsequent assessment was posted to that year.

However, in March 1980, the board's executive staff changed its policy to its current status of not reopening income years. The internal auditors noted that under this current policy, segments of an income year can be "closed out" so that the automated tax system cannot use the closed out segments in calculating interest if a subsequent assessment is posted to that year. Since the automated tax system cannot use transactions in the closed segment of the taxpayers' files, taxpayers, in certain situations, are assessed additional interest that they would not be assessed if the segments of the income year remained open.

To address this issue raised by the internal audit unit, the study team recommended that, as a short-term measure the board should not reopen the closed segments of the income year on a taxpayer's file. In addition, the board's executive staff approved the study team's recommendation to eventually redesign the bank and corporation tax system so that income years will not close until the statute of limitations has expired. Therefore, all taxpayers would receive the recalculation of interest. The study team concluded that recalculating interest by leaving income years open is equitable to all taxpayers and is the policy of the IRS.

Since the board approved changes that, in the long term, will allow income years to remain open, it would appear to imply that its current short-term measure is not equitable to all taxpayers since some taxpayers will not receive

a recalculation of interest. Moreover, the study team report did not outline a plan to identify the taxpayers who did not receive the benefit, or detriment, of a recalculation of interest by having their income years remain open. For example, according to the internal auditors, one taxpayer would have received credit for an additional \$234,000 in interest if the board had allowed the income year to remain open when the bank and corporation tax system recalculated interest. In addition, the study team's report to the board did not address the fact that its long-term solution may not be implemented before the statute of limitations expires for many taxpayers. Finally, the board has not yet determined the amount of interest that taxpayers would not have been assessed or the amount of additional interest that taxpayers would have been assessed if the income years would have been allowed to remain open; and

- The study team report concluded that some of the deficiencies of the automated tax system are critical and others are noncritical. However, the board's executive management has not provided a specific time frame for implementing corrective action for either critical or noncritical deficiencies. In some instances, time may be crucial because taxpayers may be denied refunds if the problems are not corrected before the statute of limitations precludes the payment of the refund or the recalculation of interest.

Criteria:

The Revenue and Taxation Code, Section 26071, states that if the board finds that there has been an overpayment for any reason, the amount of the overpayment may be credited against any amount then due, and the balance must be refunded to the taxpayer. In addition, a Technical Advice Memorandum approved by the board's chief legal counsel states that these amounts must be refunded even if the taxpayer has not filed a formal refund claim. Further, Section 26073 of the Revenue and Taxation Code states that, except for specified circumstances, no credit or refund must 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. Further, Section 26073.2 of the Revenue and Taxation Code allows the statute of limitations to be

extended by the taxpayer, under specific situations. The Revenue and Taxation Code, Sections 26080 through 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. A Technical Advice Memorandum approved by the board's chief legal counsel in regard to the Avon decision states that "the board is not legally required to follow federal cases and rulings. However, where, as here, 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."

Recommendation: The board should determine the amount, including the accrued interest, of the credit balances deleted because the board did not "examine or in some way review" taxpayer accounts to determine whether refunds were owed or because the amounts identified as owed to taxpayers were not refunded. Further, the board should determine the amount of interest that certain taxpayers were overassessed because since 1985 the board delayed in fully implementing the Avon decision. In addition, the board should determine the amount of interest that certain taxpayers were overassessed, because since 1980, the board has not allowed income years to remain open to recalculate interest. This information should be presented to the Legislature so it can determine whether exceptions to the statute of limitations should be made because of these conditions. Further, the board should immediately review its records to determine whether any credit balances deleted from its file of tax overpayments can be reversed before the statute of limitations prevents the board from potentially refunding these balances. The board should discontinue its practice of deleting credit balances when the statute of limitations has not expired. In addition, the board should implement procedures to ensure that it reviews its file of credit balances to ensure that it finds all credit balances that are owed to taxpayers before the statute of limitations expires. Furthermore, the board should fully implement the Avon decision so that all taxpayers receive the recalculation of interest in accordance with the Avon decision. Further, the board should either allow income years to remain open in the short-term or implement procedures to identify

taxpayers that in the short-term will not receive the benefit of open income years so that manual adjustments can be made.

Finally, the board should document a realistic time frame for correcting both critical and noncritical changes to its bank and corporation tax system.

Item 2.

Charges for Dishonored Checks Not Assessed

Finding:

The board does not assess charges on taxpayers' accounts when banks dishonor the taxpayers' checks. During the last three fiscal years, the board processed over 48,600 dishonored checks. Under current law, the board could have assessed check charges totaling over \$486,000 for these dishonored checks. Collecting these charges would offset the costs of processing dishonored checks.

We reported a similar weakness during our financial audit of the board for fiscal year 1987-88. In its February 9, 1989, response to our report, the board stated that it was conducting a study to determine whether the charge of \$10 was cost beneficial. The board noted that revenue from a dishonored check charge would be diminished by the cost of processing the charge, including making changes to its accounts receivable system, accounting for miscellaneous revenue, and increasing correspondence with taxpayers.

As of November 1989, the board was in the process of seeking a change in a statute that would allow it to implement a charge on dishonored checks without making major system changes.

Criteria:

The California Government Code, Section 6157, and the State Administrative Manual, Section 8043.1, allow the State to assess a charge for dishonored checks not to exceed \$10.

Recommendation:

The board should continue its efforts to determine if a \$10 charge for dishonored checks could be cost beneficial. If the board concludes that a \$10 charge is not cost-effective, it should seek legislation to increase the charge.

Item 3.

Delayed Payment of Tax Refunds

Finding:

The board does not consistently issue tax refunds promptly. Of the 272 tax refunds that we reviewed for bank and corporation tax and for personal income tax, the board did not process 77 refunds (28 percent) within the required number of days. As a result of these delays, some taxpayers do not receive their refunds within a reasonable period. In addition, the board is required by law to pay interest on overpayments of taxes that it does not refund within the required number of days. The board must pay this interest even if taxpayer delays in providing information cause the refund to be late. The rate of interest the board pays to taxpayers is approximately 2 percent higher than the rate of interest that the State receives on deposits in its pooled money investment program. Therefore, late refunds cause the State to incur an unnecessary interest expense.

During fiscal year 1988-89, the board incurred approximately \$71 million in interest expense on some of the approximately 143,000 refunds it made to corporate taxpayers. The board was required by statute to pay approximately \$28 million of this amount to corporate taxpayers who were being audited and who had made deposits toward estimates of tax due to stop interest from accruing. However, for an undetermined portion of the remaining \$43 million, the State incurred unnecessary interest expense because it was slow to process refunds. For example, for one of the 77 refunds we found that was not issued within the required number of days, the board incurred approximately \$5,000 in unnecessary interest expense on a total interest payment of approximately \$25,000. We also noted a similar problem with board refunds of personal income taxes. For example, for one of the delayed refunds, the board incurred approximately \$2,400 in unnecessary interest expense on a total interest payment of approximately \$13,500.

We reported a similar weakness during our financial audit of the board for fiscal year 1987-88. In its February 9, 1989, response to our report, the board noted that it had increased staffing in certain units, made processing revisions to remove time-consuming steps, and modified its automated tax system. Since the implementation of these steps may

not have occurred until late in the fiscal year, the effect of the changes may not be evident until our next audit.

Criteria: The Revenue and Taxation Code, Sections 26080 through 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. In addition, Sections 19062 through 19062.11, require the board to pay interest on overpayments of personal income taxes that it has not refunded within 45 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.

DEPARTMENT OF GENERAL SERVICES

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

Item 1. Possible Liability to the Federal Government

Finding: The department has a possible liability to the federal government estimated to be as much as \$6.9 million for profits it has accumulated in its Service Revolving Fund (SRF) between July 1, 1984, and June 30, 1989. 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 (DHHS) 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 \$10,347,000.

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 \$6.9 million. This is the federal share of profits accumulated by the SRF during the period July 1, 1984, through June 30, 1989, after audit adjustments that increased accumulated profits by \$8.2 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' cash expenditures. This amendment, if approved, may eliminate any liability to the federal government.

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 1989. 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 has not ensured that charges to federal programs are in compliance with federal regulations.

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, this could be done 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.

Item 2.

Improper Accounting for Equipment and Related Acquisitions and Disposals in the Service Revolving Fund

Finding:

The department's Office of State Printing (OSP) did not reconcile the general ledger account balance for accumulated depreciation with its detail property records and did not always properly record equipment transactions. In addition, the department's Service Revolving Fund (SRF) accounting unit did not record an intangible asset of approximately \$880,000. We found the following specific conditions:

- The OSP's general ledger account balance for accumulated depreciation at June 30, 1989, did not reconcile with the detail property records. The unreconciled difference was approximately \$48,000. As a result of not reconciling the general ledger account balance with the property records, the department may not detect and correct errors in its records;
- The OSP did not always properly record its equipment transactions during fiscal year 1988-89. For example, during our review of 18 transactions involving equipment purchases for the OSP, we found that the department recorded as an expense the cost for equipment totaling approximately \$51,000. The department paid for the equipment in two payments, and it correctly recorded the first payment as an asset; however, it incorrectly recorded the second payment as an expense. In another example, the department did not prepare a journal entry to remove approximately \$225,000 of equipment that it had disposed of during June 1989. Failure to remove equipment that had been disposed of overstates the equipment and related depreciation accounts. We brought these errors to the attention of the accounting office, which made the necessary corrections; and
- Finally, the department's SRF accounting unit did not record an intangible asset totaling approximately \$880,000. During fiscal year 1988-89, the department's Telecommunications Division signed a ten-year agreement with the Department of Water Resources for a fiber optic pair that it will use to provide ATSS services to other state agencies. In payment for the use of the fiber optic pair, the department

received a credit of approximately \$595,000 from a previous agreement signed in 1986, and it paid an additional amount of approximately \$450,000. The SRF accounting unit improperly recorded the \$595,000 as an expense in fiscal year 1985-86 when it should have recorded this amount as an intangible asset. It should have also recorded the related amortization expense totaling approximately \$164,000 between June 1986 and February 1988. Moreover, in fiscal year 1988-89, the SRF accounting unit improperly recorded the cash payment of approximately \$450,000 as an expense rather than an intangible asset. As a result, the intangible asset account of the SRF was understated by a total of approximately \$880,000, the expense account was overstated by approximately \$450,000, and the fund balance was understated by approximately \$430,000. When we brought this to the accounting unit's attention, it corrected its records and recorded the intangible asset.

Criteria: The State Administrative Manual, Section 7900, stresses the importance of monthly reconciliations. Reconciliations represent an important element of internal control because they provide additional assurance that the transactions have been correctly recorded and that the financial statements are complete. The State Administrative Manual, Section 8614, requires that the cost of equipment to be capitalized include the purchase price plus all costs to acquire, install, and prepare the equipment for its intended use. Additionally, the State Administrative Manual, Section 8621, requires agencies to remove equipment from their records after the agencies have disposed of the equipment. The State Administrative Manual, Section 8615, states that purchases that lack physical substance but give valuable rights to the owner are intangible assets. The department must account for intangibles in the general ledger account number 2410, intangible assets.

Recommendation: The department's Office of State Printing should reconcile monthly its general ledger account balance for accumulated depreciation with its property records. The Office of State Printing should also capitalize the total costs of equipment purchases, and it should ensure that it removes from the records all equipment that it has disposed of.

Finally, the Service Revolving Fund accounting unit should ensure that it records all its intangible assets.

Item 3.

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. As a result, the \$853,000 inventory balance of telecommunications equipment that the department reported at the end of fiscal year 1988-89 was understated by at least \$129,000. We reported a similar weakness during our financial audit for fiscal year 1987-88.

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 understated its inventory by approximately \$129,000 because of an error in reporting the inventory of one area. The staff had inadvertently used the prior year's count sheets to report the current year's inventory amounts;
- The department's method of pricing does not result in a recorded value that reflects the actual cost of the inventory on hand. The division prices all like-items at the same value even though the items may have been purchased at different prices. Further, the staff uses whatever information is readily available to price the inventory. For example, in some cases, the staff used the manufacturer's price book; in other cases, it used phone quotes from a manufacturer's representative. We were unable to conclude,

for 19 of the 65 items that we reviewed, that the item's recorded prices were reasonable. For these 19 items, we were not able to compare the recorded price to a price book or the division was not able to provide us with documentation of a phone quote; and

- The accounting office changes the account balance only after a physical inventory. Because the inventory was taken during the third week of April, the balance recorded as of June 30, 1989, actually reflected the status of the inventory over two months earlier.

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. Further, generally accepted accounting principles prescribe that inventories be valued at the cost of acquiring the inventories.

Recommendation: The department should ensure that the Telecommunications Division (division) correctly report 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 amount reported in the financial statements reflects the value of the inventory at June 30, the division should hold its physical inventory as close to the end of the fiscal year as possible and should analyze transactions occurring during the period between the physical inventory and the end of the fiscal year.

Item 4. Inaccurate Reporting of Liabilities in the Service Revolving Fund

Finding: The department did not properly analyze and report some of the liabilities in its Service Revolving Fund (SRF) at June 30, 1989. We found the following specific conditions:

- The SRF accounting unit incorrectly included in its liabilities approximately \$762,000. Of this amount, the department's Telecommunications Division identified for the

SRF accounting unit approximately \$651,000 as an accrual for the State's ATSS services. However, the Telecommunications Division could not provide us with an invoice, and our review of invoices through September 30, 1989, indicated that the department did not make any payments after June 30 to support this amount. In addition, the SRF accounting unit incorrectly accrued the remaining amount of an intrafund agreement for approximately \$110,000 because its accounting records did not show that it had paid this amount before June 30, 1989; and

- In addition, the accounting unit of the Office of State Printing (OSP) made errors totaling approximately \$213,000 in calculating its liabilities: The OSP could not provide us with support for approximately \$37,000 of its accounts payable; it incorrectly classified approximately \$21,000 as accounts payable even though it had paid the related invoices before June 30, 1989; and it failed to include equipment totaling approximately \$155,000 that it had purchased before June 30.

If the department does not properly identify liabilities in its financial statements, the State Controller's Office does not have sufficient information to prepare the State's financial statements in accordance with legal and 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 report liabilities in its Service Revolving Fund.

Item 5. Monies Not Transferred to the Legislature Promptly or Accurately

Finding: The department's Office of State Printing (OSP) did not always promptly or accurately transfer to the Legislature monies from the sale of legislative bills and publications. We found that the OSP transferred receipts to the Legislature at least one month late for 5 of the 12 months we reviewed. For

example, the OSP transferred its February 1989 receipts, totaling approximately \$625,000, at least three months late. In addition, for one month, the OSP did not correctly calculate the amount it should remit to the Legislature, and, as a result, it failed to transfer \$5,000. When the OSP does not promptly transfer the correct amount of legislative monies, the Legislature does not have use of these funds to pay current obligations.

Criteria: Senate Concurrent Resolution No. 3 (1987) requires the Office of State Printing to transfer to the Legislature on the first day of each month monies from the sale of legislative bills and publications.

Recommendation: The department's Office of State Printing should ensure that monies from the sale of legislative bills and publications are transferred to the Legislature promptly and accurately.

Item 6. Insufficient Controls Over 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). 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 do not transfer the funds before receiving the services and, therefore, owe funds to the department. In these situations, the department bills the agencies. We found that the department did not always bill for services promptly. 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. As a result of not billing for and collecting funds owed to the department, the department's control over its receivables is diminished, thus increasing the risk that some receivables will become uncollectible. We noted the following conditions:

- At June 30, 1989, the department's financial records indicate that the department had not yet received payment for services on

72 construction projects. For these 72 construction projects, the department bills after it provides the services. For 14 of the 72 projects, the balances were greater than \$200,000. We reviewed the 14 projects to determine if the large unpaid balances resulted from the department's not billing the state agencies promptly. We found that during fiscal year 1988-89, for 7 of the 14 projects, the department had billed only for ongoing services that the department had rendered up to January 1, 1989. The department billed for services through June 30, 1989, for 2 of the 7 projects on November 15, 1989. For another 5 projects, the department had not billed for ongoing services for the entire fiscal year until November 22, 1989, when the unit prepared invoices for 3 of these projects for some services during fiscal year 1988-89.

- We reviewed 54 projects that the department included on both its June 30, 1988, and June 30, 1989, financial statements. For these projects, the agencies owed money to the department because the department's cost of services provided exceeded the amount the agency had transferred. We found that the department failed to resolve or investigate the collectibility of funds for 35 of these projects. During fiscal year 1988-89, the department continued to charge expenses to 22 of these projects even though the department had not taken any action to collect or resolve these outstanding receivables.
- Finally, the department did not adjust the amount of project receivables owed to the ARF at June 30, 1989, for projects that the department had identified as uncollectible. Of the approximate balance of \$21 million in the project receivables account, nearly \$1.4 million represented amounts that the department had identified as uncollectible. Further, the department did not include on its list of receivables one project with an outstanding balance of approximately \$131,000. Finally, the department included approximately \$250,000 in its project receivables balance at June 30, 1989, even though it had received this amount in payment for these projects before June 30, 1989. The net result of these errors was that the department overstated the amount

of project receivables by approximately \$1.5 million on its June 30, 1989, financial statements. After we brought these errors to its attention, the department submitted corrections to the State Controller's Office.

Criteria: 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. In addition, the State Administrative Manual, Section 8776.2, requires the department to count as receivables at June 30 those receivables that the department estimates that it will collect within the following fiscal year. Finally, the State Administrative Manual, Section 8290, requires state agencies to accrue amounts represented by billed receivables if the agencies estimate that these amounts will be collected within one year after the end of the current fiscal year.

Recommendation: The department should promptly bill other state agencies for costs of construction project services. Further, the department should promptly resolve and investigate the collectibility of long-outstanding project receivables and adjust its receivables account accordingly. Finally, the department should ensure that it reports the correct amount of receivables in its financial statements.

Item 7. 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 funds from being available 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 24 completed projects to determine if the department returned unencumbered funds to agencies promptly. For 3 of the 24 projects, the department took 6 to 16 months to return unencumbered funds of the completed projects.

Further, the department does not always return unencumbered funds within three years from the time the funds are originally transferred to the ARF. We reviewed 20 projects for which funds were transferred to the ARF before June 30, 1986. Five projects had unencumbered funds at June 30, 1989; for these projects the department had not prepared the request for the return of funds within the three years required by the California Government Code. As of January 31, 1990, the department still had not prepared the request for return of funds for two of the five projects. For another project, the department had requested the return of the funds, but the State Controller's Office had not returned the funds as of January 31, 1990, approximately 7 months after the date of the department's request. For the remaining two projects, the State Controller's Office returned the funds approximately 3 and 7 months after the date of the department's request for the return of funds. Finally, a sixth project had unencumbered funds at June 30, 1989, for which the department's request for the return of funds was within the three years stated by the California Government Code; however, as of January 31, 1990, or 10 months later, the State Controller's Office had not yet returned the funds.

During our financial audits for the last five years, we reported similar delays in returning unencumbered funds within the three-month limit. Additionally, for fiscal years 1986-87 and 1987-88, 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, and we have noted improvements over the last three fiscal years; however, more improvements are needed.

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.

Recommendation: The department should ensure that it returns unencumbered balances within the time limits required by the California Government Code.

Item 8. Inadequate Analysis and Reporting of Payables and Encumbrances for the Architecture Revolving Fund

Finding: The department did not adequately analyze and report payables and encumbrances at June 30, 1989, for the Architecture Revolving Fund. We found that the department did not report approximately \$429,000 that it should have identified. This situation occurred, in part, because the department did not fully analyze all purchase orders and contracts to determine if they represented payables. Instead, the department determined its payables as of June 30, 1989, based only on invoices or estimates that it had received as of the date that the accounting office determined the amount of payables.

We reported a similar situation in fiscal year 1987-88. As a result, the department developed some procedures for estimating the amount of payables as of June 30 that had not yet been submitted for payment. The department used these procedures to improve its analyses of payables for ongoing construction projects that are billed monthly, but it did not develop procedures for estimating payables for other types of services that are not billed monthly. Therefore, the department overlooked \$429,000 of payables for services received prior to June 30, 1989. Although the department received the invoices for these services after June 30, in some instances the vendors performed the services several months before this date. We believe the department should have been able to identify these payables using other procedures.

In addition to the errors caused by the department's inadequate analysis of its payables, its accounting staff made various clerical errors, undetected by supervisory review, that resulted in an overstatement of approximately \$446,000 in payables. The largest error, approximately \$312,000, resulted because staff did not properly

record all payments to a contractor. We reported similar clerical errors during our financial audit for fiscal years 1986-87 and 1987-88.

We also identified errors in the encumbrance balances of 10 of 35 contracts included in the department's Project Management Accounting (PMA) reports. The department implemented the PMA system in fiscal year 1988-89 and used it to determine the encumbrance balance for the Architecture Revolving Fund. The errors occurred because staff did not properly enter into the PMA system the payment and encumbrance data for the contracts. After we brought this matter to its attention, the department corrected the misstatements that we identified in the PMA reports.

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.

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.

Recommendation: The department should analyze all documents to identify and record its payables at June 30 accurately. Also, the department should review the Project Management Accounting reports to ensure that the reports accurately identify the payment and encumbrance balances of all contracts. Finally, the department should ensure that supervisors review work supporting the financial statements.

Item 9. Insufficient Accountability Over Fixed Assets

Finding: The department's Office of Local Assistance (office) did not maintain sufficient accountability over fixed assets in the State School Building Aid Fund. During our audits for fiscal years 1987-88 and 1988-89, we identified the following examples:

- During fiscal year 1987-88, the office did not maintain adequate records for portable classrooms. In some cases, the office did not record applicable costs to the subsidiary property records. In other cases, the office could not locate subsidiary property records.

Additionally, the office did not adequately record assets placed into service. As a result, the office did not include in the fixed asset account balance approximately 1,300 classrooms at June 30, 1988. Thus, the office understated the fixed asset account balance, at June 30, 1988, by approximately \$37 million;

- The office did not perform monthly reconciliations of fixed asset expenditures with the property ledger cards during fiscal year 1987-88. As a result, the office did not discover that the subsidiary property records and the fixed asset account balance were incomplete; and
- During fiscal year 1988-89, the office discontinued maintaining any property ledger cards for portable classrooms. As a result, the office understated its fixed asset account balance by approximately \$55.4 million at June 30, 1989.

The office's failure to maintain sufficient control over fixed assets prevents the prompt detection of errors.

Criteria: The State Administrative Manual, Section 8650, requires that departments keep records of all capitalized property. In addition, the State Administrative Manual, Section 7969, requires that equipment expenditures be reconciled with the property ledger monthly.

Recommendation: The Office of Local Assistance should establish adequate procedures to ensure that fixed assets are properly recorded in both the subsidiary property records and the general ledger. Additionally, the office should prepare monthly reconciliations of the increase in the fixed asset account balance with monthly expenditures to identify any errors or omissions from the fixed asset account balance.

Item 10. Inadequate Controls Over Accounting Records

Finding: The department maintained inadequate controls over the accounting records for the State School Building Lease Purchase Fund. During our financial audits for fiscal years 1987-88 and 1988-89, we identified the following examples of inadequate controls:

- The records in which the department records expenditures and remaining spending authority do not agree with similar records maintained by the State Controller's Office. Although the department maintains listings of differences between the department and the State Controller's Office, the department has not evaluated these listings to determine which records are in error. We tested some transactions on these listings and identified that, at June 30, 1988, the department incorrectly recorded in its records approximately \$26.3 million of expenditures and \$23.9 million of spending authority. Further, we identified differences of approximately \$92.2 million for expenditures and \$126.6 million for spending authority that were recorded incorrectly in the records of the State Controller's Office and for which the department has failed to notify the State Controller's Office. Although the department and the State Controller's Office began to correct some of these errors during fiscal year 1988-89, we determined that the department's records at June 30, 1989, continued to reflect differences of approximately \$17.4 million for expenditures and \$16.3 million for spending authority. These differences occurred because the department had recorded some transactions incorrectly. In addition, we identified differences of \$2.6 million for expenditures and \$27.3 million for spending authority that the State Controller's Office had recorded incorrectly and that the department had failed to bring to the attention of the State Controller's Office;

- The department's subsidiary project cards, which document the detailed funding history of each project, did not reconcile with the expenditure totals posted to the general ledger for each project. Further, the department cannot provide supporting documentation for approximately \$12.3 million and \$6.2 million in the general ledger Due to Other Governments balance at June 30, 1988, and June 30, 1989, respectively. Additionally, the department paid some school districts in fiscal years 1987-88 and 1988-89 more than the State Allocation Board had authorized. As a result, the department cannot be sure that the general ledger expenditure balance or the remaining spending authority are accurate; and

- The department did not have adequate controls to be sure that all revenue transactions are properly posted in fiscal year 1987-88. For example, the department did not reconcile its revenue journal entry documents with the revenue source documents. As a result, the department posted incorrect amounts to its general ledger and subsidiary project cards for 3 of the 45 revenue documents that we tested.

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, 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 department should promptly evaluate any posting differences between its records and the records of the State Controller's Office, and it should notify the State Controller's Office of any errors in postings to its accounts. Additionally, the department should reconcile monthly its subsidiary project cards with its general ledger. Further, the department should reconcile its revenue documents so that accurate amounts are recorded to its accounting records.

STATE PERSONNEL BOARD

We reviewed the financial operations and related internal controls at the State Personnel Board (board).

Item 1. Weaknesses in Control Over Blank Check Stock and Undeposited Collections

Finding: The board did not properly control its blank check stock and undeposited collections. Specifically, we found the following weaknesses:

- The board did not properly control access to the safe containing the blank check stock and undeposited collections. The safe remained unlocked and unattended during business hours. Failure to properly safeguard the blank check stock may result in unauthorized disbursements. Failure to properly safeguard undeposited collections may result in loss or theft;
- The board did not endorse checks and warrants when it received them. Instead, the board endorsed checks and warrants as it prepared them for deposit. Failure to endorse checks upon receipt makes the board more vulnerable to loss of the checks; and
- The board did not record dates of receipt of cash collections and did not deposit receipts promptly. During fiscal year 1987-88, the board made 25 deposits averaging approximately \$150,000 each with an average of ten working days between deposits. When the board holds deposits for an excessively long period, there is an increased risk of loss from fire or theft. Furthermore, the State loses interest earnings on undeposited checks and currency.

Criteria: The State Administrative Manual, Section 8041, requires agencies to keep their blank check stock under strict control at all times. In addition, the State Administrative Manual, Section 8023, requires agencies to endorse all checks, money orders, and warrants on the day received. Furthermore, the State Administrative Manual, Section 8092, requires agencies to record the date of receipt for each collection. Finally, the State Administrative

Manual, Section 8030.1, requires agencies to deposit collections of \$50 or more within five working days after the money is received.

Recommendation: The board should ensure that its blank check stock and undeposited collections are properly safeguarded at all times. Moreover, the board should endorse checks, money orders, and warrants no later than the end of the day of receipt; record the date of receipt for each collection; and deposit collections of \$50 or more within five working days.

Item 2. Long-Outstanding Salary Advances

Finding: The board did not promptly collect outstanding salary advances made to employees from the revolving fund. As of June 30, 1988, the board had a total of \$20,875 in outstanding salary advances, of which \$7,040 (34 percent) had been outstanding for more than a year. The board had not established adequate procedures or assigned responsibility for clearing salary advances. Outstanding advances can be cleared through collections, which includes income tax offset procedures, or by requesting relief for accountability from the State Board of Control. 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. Further, until the board takes appropriate action either to collect or to write off these outstanding advances, this revolving fund money is not available for other uses.

Criteria: The State Administrative Manual, Section 8118, requires the board to collect outstanding salary advances from the subsequently issued payroll warrant for the time period covered by the salary advance. In addition, the State Administrative Manual, Section 8710.1, states that if all reasonable collection procedures do not result in payment, the board may request relief from accountability for uncollectible amounts by filing an Application for Discharge from Accountability.

Recommendation: The board should collect outstanding salary advances from the subsequently issued payroll warrant for the time period covered by the salary advance. The board should also pursue collection of old outstanding salary advances. If other collection efforts fail, the board should attempt to recover the advances made to employees who have left state

service through the income tax offset procedures of the Franchise Tax Board. Finally, the board should request from the State Board of Control release from accountability for those salary advances that are still uncollectible.

Item 3. **Lack of Separation of Duties**

Finding: The board does not adequately separate duties in its accounting department. The accounting officer signs checks, reconciles bank accounts, posts transactions as a backup to other personnel, and has access to the blank check stock. Without proper separation of duties, employees can conceal irregularities and management may be unable to determine who is responsible for errors. According to the accounting officer, the small size of the accounting office makes it impossible to completely separate all incompatible duties.

Criteria: The State Administrative Manual, Section 8080, lists seven duties that should be separated among employees working with manual accounting systems. Among these duties are signing checks, reconciling bank accounts, and posting the general ledger or subsidiary ledgers affected by cash transactions. Furthermore, persons performing these duties should not have access to the blank check stock. If an agency cannot comply with Section 8080, it should obtain exemption through written approval from the Fiscal Systems and Consulting Unit of the Department of Finance.

Recommendation: The board should reassign duties among employees in the accounting office to ensure proper separation of duties. If the number of staff is not large enough to achieve proper separation of duties, or if such a reassignment would cause operational difficulties, the board should obtain the Department of Finance's approval for an exemption from the requirement.

Item 4. **Failure To Review Monthly Reconciliations**

Finding: No one at the board reviewed monthly bank reconciliations, revolving fund reconciliations, and reconciliations of appropriation balances of the State Controller's Office with unspent allotments. The accounting officer prepared the reconciliations himself. However, when reconciliations are not signed and dated by a reviewer, the board cannot be certain that reconciliations are prepared correctly.

Reconciliations are an important part of internal control because they provide a high degree of assurance that transactions have been properly recorded and that financial records are complete.

Criteria: The State Administrative Manual, Section 7908, requires that reconciliations show the name of a reviewer and date of review.

Recommendation: The board should ensure that reconciliations show the name of a reviewer and date of review.

YOUTH AND ADULT CORRECTIONAL

BOARD OF CORRECTIONS

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

Item Understatement of Liabilities

Finding: The board's year-end financial reports for its three capital expenditure funds were inaccurate. Specifically, the Department of the Youth Authority, which performs accounting for the board, did not include on the board's balance sheet amounts that were due to other governments under long-term contractual agreements. Consequently, the board's due to other governments and expenditures accounts were understated for the following three capital expenditure funds: for the 1986 County Correctional Facility Capital Expenditure Fund, the due to other governments and expenditures accounts were understated by \$33,960,440; for the County Jail Capital Expenditure Fund-Bond Act of 1981, the due to other governments and expenditures accounts were understated by \$17,701,460; and for the County Jail Capital Expenditure Fund-Bond Act of 1984, the due to other governments and expenditures accounts were understated by \$6,162,804.

The Department of the Youth Authority also did not analyze the long-term contractual agreements to determine if they represented encumbrances or obligations at year end. If the board and the Department of the Youth Authority do not properly identify the board's liabilities, expenditures, and encumbrances, the State Controller's Office does not have accurate information to prepare the State's financial statements in accordance with generally accepted accounting principles.

Criteria: The State Administrative Manual, Section 7630, requires that amounts due to other governments for outstanding obligations be reported as due to other governments. In addition, the State Administrative Manual, Section 10544, requires agencies to analyze their encumbrances to determine whether they are valid obligations as of June 30.

Recommendation: The board should ensure that the Department of the Youth Authority prepares complete and accurate year-end financial reports for the board in accordance with the requirements of the State Administrative Manual.

DEPARTMENT OF CORRECTIONS

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

Item

Improper Identification of Encumbrances

Finding:

For its four construction funds, the department incorrectly identified and reported to the State Controller's Office accounts payable and amounts due to other funds as encumbrances. Specifically, for its New Prison Construction Fund, we calculated that the department incorrectly reported \$178,959 of accounts payable and \$486,663 of due to other funds as encumbrances. For its 1984 Prison Construction Fund, we calculated that the department incorrectly reported \$305,270 of due to other funds as encumbrances. For its 1986 Prison Construction Fund, we calculated that the department incorrectly reported approximately \$943,000 of accounts payable as encumbrances. For its 1988 Prison Construction Fund, we calculated that the department incorrectly reported approximately \$373,600 of accounts payable as encumbrances. These errors occurred because the department did not thoroughly analyze its commitments to determine if goods or services were received before or after June 30. If the department does not properly identify encumbrances, accounts payable, and amounts due to other funds in its financial statements, the State Controller's Office does not have accurate information to prepare the State's financial statements in accordance with generally accepted accounting principles.

We reported a similar weakness in our financial audits of the department for fiscal years 1986-87 and 1987-88. The department responded that it would complete a detailed analysis of its accruals at the end of each fiscal year. The department has implemented procedures to analyze its accruals at year end. However, its accounting office needs to improve its communication with other units in the department and other departments to ensure that it has the most current information with which to analyze its accruals.

Criteria:

The State Administrative Manual, Section 10544, requires state 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: During year-end closing, the department should ensure that it has all available information in order to analyze its accruals to determine whether goods were received or services provided before or after June 30. The department should then appropriately report its accruals as accounts payable, due to other funds, or encumbrances.

CALIFORNIA STATE PRISON AT FOLSOM

We reviewed the financial operations and related internal controls at the Department of Corrections, California State Prison at Folsom (institution).

Item 1. Failure To Return Undelivered Payroll Warrants

Finding: The institution failed to return to the State Controller's Office eight undelivered payroll warrants over 90 days old that totaled approximately \$2,000. The failure to return the undelivered payroll warrants to the State Controller's Office occurred because the responsible accounting staff were not aware of the State Administrative Manual section requiring the return of undelivered payroll warrants to the State Controller's Office after 90 days. Failure to return undelivered payroll warrants to the State Controller's Office increases the risk of the loss or theft of warrants.

Criteria: The State Administrative Manual, Section 8580.5, requires state agencies to return all undelivered payroll warrants to the State Controller's Office after 90 days for deposit in the Special Deposit Fund as unclaimed money.

Recommendation: The institution should establish procedures to identify and return to the State Controller's Office undelivered payroll warrants over 90 days old for deposit in the Special Deposit Fund.

Item 2. Failure To Cancel Outstanding Warrants Over Two Years Old

Finding: The institution failed to cancel all general checking account warrants remaining outstanding after two years. The institution should cancel such outstanding warrants to provide better cash management and to allow for remittance of funds to the Special Deposit Fund for unclaimed monies.

Criteria: The State Administrative Manual, Section 8042, requires state agencies to cancel general checking account warrants outstanding over two years to allow for deposit in the Special Deposit Fund as unclaimed money.

Recommendation: The institution should establish procedures to identify and cancel general checking account warrants outstanding over two years for deposit in the Special Deposit Fund.

Item 3. **Inadequate Separation of Duties**

Finding: The institution does not have adequate separation of duties over all receipts and disbursements. Specifically, the employee who prepares disbursement checks also mails and distributes the checks. In addition, the employee who receives remittances also enters receipts information into the accounting records. Failure to maintain proper separation of duties can result in errors, irregularities, or illegal acts that may go undetected for extended periods.

Criteria: The State Administrative Manual, Sections 8080 and 8080.1, prescribes separation of duties for state agencies. Section 8080 specifies that the employee who prepares the checks will not mail or distribute the checks, and Section 8080.1 specifies that the employee who receives remittances may not record receipts information.

Recommendation: The institution should reassign duties within the accounting office to provide the separation of duties required by the State Administrative Manual.

MULE CREEK STATE PRISON

We reviewed the financial operations and related internal controls at the Department of Corrections, Mule Creek State Prison (institution).

Item 1. Incorrect Year-End Financial Reports

Finding: The institution did not follow the State Administrative Manual when it prepared the financial reports for the year ended June 30, 1988, for its portion of the State's General Fund. As a result, it reported incorrect amounts to the State Controller's Office. We found the following specific deficiencies:

- The institution recorded an advance of approximately \$380,000 to the Prison Industries Revolving Fund as an expenditure rather than as a prepayment to other funds. It also reduced existing encumbrances by approximately that amount although it had not received the corresponding goods or services. Consequently, as of June 30, 1988, prepayments to other funds and due to other funds were understated by approximately \$380,000;
- The institution incorrectly reported in its preclosing trial balance \$113,000 of due to other funds as accounts payable. As a result, accounts payable were overstated by approximately \$113,000 and due to other funds were understated by the same amount; and
- The institution overstated its claims filed balance as of June 30, 1988, since the listing of claims filed included claims that the State Controller's Office had already paid or reduced as of June 30, 1988. As a result, the institution overstated its claims filed balance as of June 30, 1988, by \$68,645.

Criteria: The State Administrative Manual, Sections 7620 through 7680, describes the proper accounts to use in preparing correct financial reports. Specifically, Section 7620 discusses prepayments and Section 7630 discusses accounts payable and due to other funds. In addition, the State Administrative Manual, Sections 10401 through 10553, describes the entries used to record accounting data in the various accounts. Specifically, Sections 10419,

10440, 10441, and 10442 describe the entries for prepayments, claims filed, and due to other funds, respectively.

Recommendation: The institution should prepare correct financial reports in accordance with the State Administrative Manual.

Item 2. Failure To Prepare Monthly Reconciliations of the Revolving Fund

Finding: The institution has not prepared the monthly reconciliations of its revolving fund since June 1988. According to the institution, continued vacancies in the revolving fund unit during the year prevented the accounting staff from preparing the reconciliations promptly. However, failure to prepare the reconciliations promptly and consistently can prevent the early detection of errors and irregularities such as unauthorized or excessive disbursements.

Criteria: The State Administrative Manual, Section 7964, requires the institution to reconcile its revolving fund accounts at the end of each month.

Recommendation: The institution should reconcile its revolving fund promptly at the end of each month.

Item 3. Errors in Processing Invoices for Payment

Finding: The institution does not consistently follow appropriate procedures for the payment of invoices. We found the following discrepancies in processing invoices:

- Of the 118 invoices tested, the institution authorized payment of 4 invoices without evidence of receipt of goods. By not verifying that goods or services are received it is possible that the institution will pay for goods or services that it has not received; and
- The institution did not take advantage of two of the seven discounts offered by vendors in the sample of invoices. As a result, it lost \$122 from the two missed vendor discounts.

Criteria: The State Administrative Manual, Section 8422.1, requires the institution to determine that invoiced items have been received and that cash discounts have been taken before submitting invoices for payment.

Recommendation: The institution should comply with Section 8422.1 of the State Administrative Manual to ensure correct processing of invoices.

Item 4. Incorrect Payments to Employees Who Left State Service

Finding: The institution did not always pay its employees correctly when they left state service. Specifically, in our test of five employees who left state service, we found that the institution's personnel unit incorrectly paid four employees. For two of the employees, the personnel unit incorrectly calculated the lump-sum hours for which the employees were to be paid. For the other two employees, the personnel unit calculated the correct amount, but did not follow up to ensure that the amount calculated was actually paid. As a result, the institution underpaid four employees approximately \$2,900.

Criteria: The State Personnel Transactions Manual, Section 623, details the procedures for calculating the lump-sum payments to employees who leave state service.

Recommendation: The institution should follow the correct procedures for processing payments to employees who leave state service.

Item 5. Failure To Require Two Check Signatures

Finding: In our test of checks over \$15,000 that were not payable to another state agency, we found one check that did not have the required two authorizing signatures. Failure to obtain two authorizing signatures on checks over \$15,000 increases the risk that a large sum of money is disbursed improperly.

Criteria: The State Administrative Manual, Section 8001.2, requires that all checks in excess of \$15,000 have two authorizing signatures unless the payee is a state agency or the Department of Finance has permitted a deviation.

Recommendation: The institution should require all checks drawn in excess of \$15,000 to have two authorizing signatures unless the payee is a state agency.

Item 6. Incorrect Identification of Encumbrances

Finding: On the Report of Accruals to the State Controller's Accounts for its general fund, the institution incorrectly identified approximately \$114,000 of current liabilities as encumbrances. The errors occurred because the institution's accounting personnel did not adequately analyze its encumbrances at June 30 to determine which goods or services were received before June 30. If the institution does not correctly identify encumbrances in its financial reports, the State Controller's Office does not have accurate information for preparing the State's financial statements in accordance with generally accepted accounting principles.

Criteria: The State Controller's Office issued a memorandum, dated May 20, 1988, instructing agencies to report the amount of encumbrances so that the State's financial statements can be prepared in accordance with generally accepted accounting principles. Under such principles, encumbrances are commitments to purchase goods or services to be received in the next fiscal year.

Recommendation: During year-end closing, the institution should more carefully analyze its encumbrances to determine which goods or services were received before or after June 30. The institution should correctly report encumbrances on its Report of Accruals to the State Controller's Accounts.

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.

Item 1. Improper Reporting of Obligations and Encumbrances

Finding: The department incorrectly reported to the State Controller's Office the amount of its obligations and encumbrances as of June 30, 1989. We found the following specific deficiencies:

- The department overstated its encumbrances by approximately \$223,500. Specifically, the department improperly reported as encumbrances approximately \$64,500 for goods or services that it had received before June 30, approximately \$124,000 related to four contracts that were cancelled or completed, and approximately \$35,000 that it had recorded twice;
- The department understated its obligations by approximately \$19,000 because it did not include two invoice amounts in its year-end accruals; and
- The department incorrectly classified approximately \$14,000 of amounts due to local governments as accounts payable.

As a result of these errors, the department understated its obligations by approximately \$83,500 and overstated its encumbrances by approximately \$223,500. If the department does not properly identify encumbrances, accounts payable, and amounts due to other funds and governments in its financial statements, the State Controller's Office does not have accurate information to prepare the State's financial statements in accordance with generally accepted accounting principles.

We reported a similar weakness in our financial audit of the department for fiscal year 1987-88. The department responded that it had instructed its staff on the proper reporting procedures. However, the department continues to incorrectly report its

accounts payable, amounts due to other funds, amounts due to other governments, and its encumbrances.

Criteria: The State Administrative Manual, Section 10544, requires agencies to analyze their obligations and encumbrances to determine whether they are valid obligations as of June 30. In addition, a State Controller's Office memorandum, dated May 31, 1989, requires agencies to accurately report in their financial statements the amount of encumbrances. Further, the State Administrative Manual, Section 7630, requires that amounts owed to vendors, other funds, or other governments but not paid at year end be reported as accounts payable, due to other funds, or due to other governments.

Recommendation: The department should analyze its accruals to determine whether goods or services were received before or after June 30 and should report them appropriately as obligations or encumbrances. In addition, the department should ensure that all amounts owed to vendors, other funds, and other governments are included in its year-end accruals.

Item 2. Inaccurate Meal Count Reports

Finding: The Ventura School did not report accurate meal counts to the headquarters office for fiscal year 1988-89. According to our review of the supporting documentation for 48 meal counts, the Ventura School's total of 43,457 breakfasts and lunches was overstated by at least 702 meals. The Ventura School overstated the total number of meals on its monthly reports to headquarters because it incorrectly based its meal counts on the ward population rather than on actual meals served. In addition, the reports included meals served to ineligible staff, double-counted meals, and arithmetic errors.

The department uses the monthly meal count reports to charge the State Department of Education for meals served to eligible students under the School Breakfast Program and the National School Lunch Program. Although the department reduced the Ventura School's meal counts for some of the double-counting, the department still charged the State Department of Education for meals that were not eligible for reimbursement and for more meals

than the Ventura School actually served. We reported a similar weakness in our audit of the department for fiscal year 1987-88. The department agreed that its facilities must report accurate meal counts and maintain records to support their meal counts.

Criteria: The Code of Federal Regulations, Title 7, Sections 210.9(b)(8) and 220.7(e)(6), states that only meals served to eligible students may be claimed for reimbursement at the assigned rates. In addition, the Code of Federal Regulations, Title 7, Sections 210.15(b) and 220.9(a), specifies that to participate in the School Breakfast Program and the National School Lunch Program, a facility must maintain records to demonstrate compliance with program requirements.

Recommendation: The department should ensure that its facilities report accurate meal counts and maintain records to support their meal counts so that the department charges the State Department of Education for the correct number of meals served.

Item 3. 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 found the following specific deficiencies:

- The Ventura School did not provide the required serving sizes or the required servings of milk or fruits and vegetables for 15 of the 48 breakfast and lunch meals that we reviewed. In addition, the facility did not document the quantity of meat or meat alternate that it served for seven lunches. Consequently, we could not determine if the amount provided satisfied the federal serving size requirements;
- The El Paso de Robles School did not provide the required serving sizes for meat or a meat alternate for 2 of the 48 breakfast and lunch meals that we reviewed. In addition, the facility did not document the quantity of meat or meat alternate that it used for one lunch. Consequently, we could not determine if the

amount provided satisfied the federal serving size requirements; and

- The Northern Reception Center-Clinic did not provide the required serving size for fruits and vegetables 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 National School Lunch and School Breakfast programs.

Recommendation: The department should ensure that its facilities serve at least the minimum required amounts of food items at meals reimbursed under the National School Lunch and School Breakfast programs.

Item 4. Noncompliance with Certain State Requirements

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

- The department did not cancel eight general cash and revolving fund warrants totaling \$984 that were outstanding for over two years and transfer the money to the Special Deposit Fund. The State Administrative Manual, Section 8042, requires agencies to cancel general cash and revolving fund warrants outstanding over two years and transfer the money to the Special Deposit Fund as unclaimed property. We reported a similar weakness in our financial audit of the department for fiscal year 1987-88; and
- For each of the first eight months of fiscal year 1988-89, the department overdrew its revolving fund by an average of approximately \$372,000 per month. The State Administrative Manual, Section 8047, requires agencies to make every effort to prevent overdrafts in their checking accounts. We reported a similar

weakness in our financial audit of the department for fiscal year 1987-88.

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

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

REPORT ON COMPLIANCE
WITH FEDERAL GRANT REQUIREMENTS



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STATE OF CALIFORNIA
Office of the Auditor General

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660 J STREET, SUITE 300
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Members of the Joint Legislative Audit Committee
State of California

We have audited the State of California's compliance with the 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 the State's major federal financial assistance programs, which are identified in the accompanying schedule of federal financial assistance, for the year ended June 30, 1989. The management of state agencies 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 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. Those standards and the 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 about the State's compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

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 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 requirements referred to above. We discuss those instances of noncompliance and present recommendations to correct them on pages 65 through 300 of our report. Management's comments regarding the recommendations appear on page 353 of this report. Additionally, beginning on page 339, 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 Department of Finance. The instances of noncompliance identified in the State's single audit report for fiscal year 1987-88 that have not been corrected are included in the section beginning on page 65. 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 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 the State's major federal financial assistance programs for the year ended June 30, 1989.

In connection with our audit of the State's general purpose financial statements for fiscal year 1988-89 and with our study and evaluation of the State's internal control systems used to administer federal financial assistance programs, as required by the OMB, Circular A-128, we selected certain transactions applicable to certain nonmajor federal financial assistance programs.

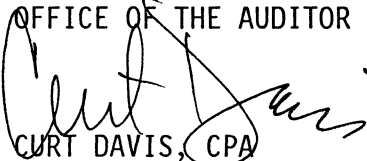
As required by the OMB, Circular A-128, we have performed auditing procedures to test compliance with the requirements governing types of services allowed or unallowed, eligibility, and any special tests and provisions that are applicable to those transactions. Our procedures were substantially less 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.

With respect to the items tested, the results of those procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. 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 65 through 300 and on page 339.

We present the Schedule of Federal Assistance on page 309. 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, 1989; it also indicates the grants that we reviewed. 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, 1988, to December 31, 1989, begins on page 331 of this report.

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 23, 1990

**SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 1989**

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Department of Agriculture:		
Farm Labor Housing Loans and Grants	10.405	\$ 1 94,930
Food Distribution	10.550	106,780,965 A *
Food Stamps	10.551	731,658,758 A **
School Breakfast Program	10.553	68,323,413 A
National School Lunch Program	10.555	353,472,223 A
Special Milk Program for Children	10.556	952,352
Special Supplemental Food Program for Women, Infants, and Children	10.557	169,772,959 A
Child and Adult Care Food Program	10.558	80,141,691 A *
Summer Food Service Program for Children	10.559	938,461 *
State Administrative Expenses for Child Nutrition	10.560	6,376,713
State Administrative Matching Grants for Food Stamp Program	10.561	118,449,674 A
Nutrition Education and Training Program	10.564	304,645
Temporary Emergency Food Assistance (Administrative Costs)	10.568	31,456,272 A *

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Forestry Research	10.652	18,000
Cooperative Forestry Assistance	10.664	931,764
Schools and Roads--Grants to States	10.665	63,310,875 A
Schools and Roads--Grants to Counties	10.666	234,819
Resource Conservation and Development	10.901	60,900
Other--U.S. Department of Agriculture	10.999	1,119,284
Department of Commerce:		
Economic Development--Support for Planning Organizations	11.302	124,000
Special Economic Development and Adjustment Assistance Program--Sudden and Severe Economic Dislocation and Long-Term Economic Deterioration	11.307	21,000
Anadromous and Great Lakes Fisheries Conservation	11.405	360,234
Interjurisdictional Fisheries Act of 1986	11.407	319,534
Coastal Zone Management Program Administration Grants	11.419	1,862,308
Coastal Zone Management Estuarine Research Reserves	11.420	394,092
Fisheries Development and Utilization Research and Development Grants and Cooperative Agreements Program	11.427	11,901

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Other--U.S. Department of Commerce	11.999	77,247
Department of Defense:		
Flood Plain Management Services	12.104	(1,257)
Flood Control Projects	12.106	91,466
Navigation Projects	12.107	65,315
Other--U.S. Department of Defense	12.999	1,934,308
Department of Health and Human Services:		
Food and Drug Administration-- Research	13.103	286,078
Maternal and Child Health Federal Consolidated Programs	13.110	57,000
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	13.116	376,600
Acquired Immunodeficiency Syndrome (AIDS) Activity	13.118	5,282,497
Mental Health Planning and Demonstration Projects	13.125	6,374
Emergency Medical Services for Children	13.127	209,100
Refugee Assistance - Mental Health	13.128	148,915
Alcohol, Drug Abuse Treatment and Rehabilitation Block Grant	13.141	13,423,168
Drug and Alcohol Abuse--High-Risk Youth Demonstration Grants	13.144	555,850

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
AIDS Drug Reimbursements	13.146	2,263,385
Mental Health Services for the Homeless Block Grant	13.150	1,209,536
Project Grants for Health Services to the Homeless	13.151	1,454,970
State Comprehensive Mental Health Service Planning Development Grants	13.158	732
Mental Health Research Grants	13.242	50,627
Mental Health Clinical or Service Related Training Grants	13.244	82,678
Childhood Immunization Grants	13.268	800,000
Centers for Disease Control-- Investigations and Technical Assistance	13.283	147,469
Professional Nurse Traineeships	13.358	116,179
Nursing Student Loans	13.364	74,766
Cancer Control	13.399	99,705
Administration on Developmental Disabilities--Basic Support and Advocacy Grants	13.630	4,612,938
Special Programs for the Aging-- Title III, Part B--Grants for Supportive Services and Senior Centers	13.633	28,237,341 A
Special Programs for the Aging-- Title III, Part C--Nutritional Services	13.635	36,574,574 A
Special Programs for the Aging-- Title III, Part D--In-Home Services for Frail Older Individuals	13.641	640,380

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Child Welfare Services--State Grants	13.645	28,301,700 A
Administration for Children, Youth and Families--Adoption Opportunities	13.652	1,650
Temporary Child Care and Crisis Nurseries	13.656	51,970
Foster Care--Title IV-E	13.658	177,466,086 A
Adoption Assistance	13.659	14,565,283
Social Services Block Grant	13.667	290,679,685 A 0
Special Programs for the Aging--Title IV--Training, Research, and Discretionary Projects and Programs	13.668	289,230
Administration for Children, Youth and Families--Child Abuse and Neglect State Grants	13.669	113,029
Family Violence Prevention and Services	13.671	637,940
Child Abuse Challenge Grants	13.672	817,584
Grants to States for Planning and Development of Dependent Care Programs	13.673	537,607
Independent Living	13.674	6,161,654
Medical Assistance Program	13.714	3,202,433,696 A
Medicare--Hospital Insurance	13.773	2,435,318
Medicare--Supplementary Medical Insurance	13.774	6,995,330
State Medicaid Fraud Control Units	13.775	6,200,772

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
State Survey and Certification of Health Care Providers and Suppliers	13.777	9,060,948 0
Family Support Payments to States-- Assistance Payments	13.780	2,307,718,297 A
Assistance Payments--Research	13.782	66,682
Child Support Enforcement	13.783	115,268,678 A
Child Support Enforcement Interstate Grants	13.785	11,966
State Legalization Impact Assistance Grants	13.786	146,473,950 A
Refugee and Entrant Assistance-- State Administered Programs	13.787	181,957,722 A
Low-Income Home Energy Assistance	13.789	76,504,411 A
Work Incentive Program/WIN Demonstration Program	13.790	14,641,666
Community Services Block Grant	13.792	30,161,630 A
Community Services Block Grant Discretionary Awards--Community Food and Nutrition	13.795	55,378
Social Security--Disability Insurance	13.802	93,093,107 A
Arthritis, Musculoskeletal, and Skin Diseases Research	13.846	60,074
Microbiology and Infectious Diseases Research	13.856	60,075
Preventive Health Services-- Sexually Transmitted Diseases Control Grants	13.977	1,245,916

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Preventive Health Services-- Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	13.978	64,275
Mental Health Disaster Assistance and Emergency Mental Health	13.982	117,728
Health Programs for Refugees	13.987	2,220,000
Cooperative Agreements for State- Based Diabetes Control Programs	13.988	97,800
Preventive Health and Health Services Block Grant	13.991	5,549,680
Alcohol and Drug Abuse and Mental Health Services Block Grant	13.992	45,619,753 A
Maternal and Child Health Services Block Grant	13.994	19,968,023
Other--Department of Health and Human Services	13.999	4,828,680
Department of Housing and Urban Development:		
Lower Income Housing Assistance Program	14.156	19,556,846
Supportive Housing Demonstration Program	14.178	851,469
Community Development Block Grants/State's Program	14.228	18,777,219
Emergency Shelter Grants Program	14.231	1,694,995
Equal Opportunity in Housing	14.400	304,025
Solar Energy and Energy Conservation Bank	14.550	84,900

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Department of the Interior:		
Small Reclamation Projects	15.503	421,039
Anadromous Fish Conservation	15.600	182,993
Sport Fish Restoration	15.605	6,774,644
Wildlife Restoration	15.611	2,426,768
Endangered Species Conservation	15.612	355,660
Earthquake Hazards Reduction Program	15.807	48,051
Historic Preservation Fund Grants-In-Aid	15.904	838,557
Outdoor Recreation--Acquisition, Development, and Planning	15.916	3,019,370
Federal Reimbursements	15.992	79,446
Shared Revenue--Potash/Sodium Lease	15.999	20,691,384 A
Outer Continental Shelf Lands Act Amendments of 1985	15.999	10,457,911
Other--U.S. Department of the Interior (Comprehensive Planning Assistance)	15.999	7,811
Other--U.S. Department of the Interior	15.999	3,167,248
Department of Justice:		
Juvenile Justice and Delinquency Prevention--Allocation to States	16.540	4,786,149
Juvenile Justice and Delinquency Prevention--Special Emphasis and Technical Assistance	16.541	28,039

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Criminal Justice Statistics Development	16.550	164,975
Justice Research and Development Project Grants	16.560	4,484,510
Maribel-Cubans	16.572	217,906
Criminal Justice Discretionary Grants	16.574	2,391,863
Crime Victim Assistance	16.575	3,414,032 0
Crime Victim Compensation	16.576	16,691,000
State and Local Narcotics Control Assistance	16.579	17,151,602 0
Other--Department of Justice	16.999	583,195
Department of Labor:		
Labor Force Statistics	17.002	4,251,281
Employment Service	17.207	84,719,671 A 0
Unemployment Insurance	17.225	241,506,784 A 0
Senior Community Service Employment Program	17.235	5,388,764
Employment and Training Assistance--Dislocated Workers	17.246	21,805,559 A
Job Training Partnership Act	17.250	264,971,120 A 0
Occupational Safety and Health	17.500	4,802,063
Mine Health and Safety Grants	17.600	160,510
Disabled Veterans Outreach Program	17.801	9,291,710
Veterans Employment Program	17.802	981,528
Local Veterans Employment Representative Program	17.804	5,441,905

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Other--U.S. Department of Labor	17.999	541,931
Department of Transportation:		
Boating Safety Financial Assistance	20.005	2,409,130
Airport Improvement Program	20.106	363,358
Highway Planning and Construction	20.205	1,058,670,504 A
Motor Carrier Safety	20.217	2,173,593
Local Rail Service Assistance	20.308	29,740
Urban Mass Transportation Capital Improvement Grants	20.500	3,511,912 0
Urban Mass Transportation Technical Studies Grants	20.505	366,936 0
Urban Mass Transportation Capital and Operating Assistance Formula Grants	20.507	1,699,506 0
Public Transportation for Nonurbanized Areas	20.509	3,159,108
State and Community Highway Safety	20.600	10,301,535
Pipeline Safety	20.700	61,408
State Marine Schools	20.806	100,000
Federal Reimbursements	20.991	5,000
Other--U.S. Department of Transportation	20.994	339,450
Department of the Treasury:		
Other--U.S. Department of Treasury	21.999	323,850

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>	
Office of Personnel Management:			
Intergovernmental Personnel Act (IPA) Mobility Program	27.011	66,736	
Equal Employment Opportunity Commission:			
Employment Discrimination--State and Local Anti-Discrimination Agency Contracts	30.002	1,725,770	
General Services Administration:			
Donation of Federal Surplus Personal Property	39.003	416,343	*
National Aeronautics and Space Administration:			
Aerospace Education Services Project	43.001	22,345	
National Foundation on the Arts and the Humanities:			
Promotion of the Arts--Dance	45.002	49,000	
Promotion of the Arts--Arts in Education	45.003	149,450	
Promotion of the Arts--State Programs	45.007	526,000	
Promotion of the Arts--Visual Arts	45.009	14,000	
Promotion of the Arts--Folk Arts	45.015	18,096	
Promotion of the Humanities- Elementary and Secondary Education in the Humanities	45.127	4,516	

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Promotion of the Humanities-Fellowships for College Teachers and Independent Scholars	45.143	13,748
National Science Foundation:		
Engineering Grants	47.041	103,454
Materials Development, Research, and Informal Science Education	47.067	16,311
Undergraduate Science, Engineering, and Mathematics Education	47.071	25,421
Small Business Administration:		
Business Development Assistance to Small Business	59.005	9,600
Veterans Administration:		
Grants to States for Construction of State Home Facilities	64.005	6,446,872
Veterans State Domiciliary Care	64.014	1,913,695
Veterans State Nursing Home Care	64.015	4,203,229
Veterans State Hospital Care	64.016	174,375
Veterans Educational Assistance	64.111	76,338
State Approval Agency Contract	64.999	982,247
Environmental Protection Agency:		
Air Pollution Control--Program Support	66.001	3,368,757
Air Pollution Control--Technical Training	66.006	113,500

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Air Pollution Control--National Ambient Air and Source Emission Data	66.007	64,824
Construction Grants for Wastewater Treatment Works	66.418	731,089
Water Pollution Control--State and Interstate Program Support	66.419	3,682,116
State Underground Water Source Protection	66.433	439,371
Water Pollution Control--Lake Restoration Cooperative Agreements	66.435	403,472
Construction Management Assistance	66.438	7,776,763
Water Quality Management Planning	66.454	1,361,409
National Estuary Program	66.456	149,792
Nonpoint Source Reservation	66.459	484,866
Solid Waste Disposal Research	66.504	1,510,616
Water Pollution Control--Research Development and Demonstration	66.505	(37,577)
Safe Drinking Water Research and Demonstration	66.506	2,911,111
Toxic Substances Research	66.507	169,103
Toxic Substances Compliance Monitoring Cooperative Agreements	66.701	100,683
Hazardous Waste Management State Program Support	66.801	4,650,168
Hazardous Substance Response Trust Fund	66.802	3,644,113

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
State Underground Storage Tanks Program	66.804	510,517
Underground Storage Tank Trust Fund Program	66.805	393,982
Other--U.S. Environmental Protection Agency	66.999	924,398
Action:		
Foster Grandparent Program	72.001	877,549 0
Service-Learning Programs	72.005	8,198
Department of Energy:		
State Energy Conservation	81.041	365,404
Weatherization Assistance for Low-Income Persons	81.042	1,633,803
Energy Extension Service	81.050	268,437
Energy Conservation for Institutional Buildings	81.052	224,388
Remedial Action and Waste Technology	81.092	486,281
Other--U.S. Dept. of Energy	81.999	72,172
Federal Emergency Management Agency:		
Flood Insurance	83.100	59,967
Emergency Management Institute--Field Training Program	83.403	511,895
Civil Defense--State and Local Emergency Management Assistance	83.503	5,223,537
State Disaster Preparedness Grants	83.505	6,258

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
State and Local Emergency Operating Centers	83.512	353,715
Population Protection Planning	83.514	512,187
Emergency Broadcast System Guidance and Assistance	83.515	4,887
Disaster Assistance	83.516	20,932,936 A
Earthquake Hazards Reduction Grants	83.521	724,837
Radiological Defense	83.522	649,909
Other--U.S. Federal Emergency Management Agency	83.999	23,201
Department of Education:		
Adult Education-- State-Administered Basic Grant Program	84.002	8,989,246
Bilingual Education	84.003	1,211,349
Civil Rights Technical Assistance and Training	84.004	800,341
Supplemental Educational Opportunity Grants	84.007	7,655,038
Education of Handicapped Children in State Operated or Supported Schools	84.009	1,228,473
Educationally Deprived Children-- Local Educational Agencies	84.010	296,522,001 A
Migrant Education--Basic State Formula Grant Program	84.011	85,183,572 A
Educationally Deprived Children-- State Administration	84.012	4,310,474
Neglected and Delinquent Children	84.013	3,272,489

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>	
Handicapped Early Childhood Education	84.024	(849)	
Handicapped Education-- Deaf-Blind Centers	84.025	329,943	
Handicapped--State Grants	84.027	132,787,643	A
Handicapped Education-- Special Education Personnel Development	84.029	246,103	
Higher Education Act Insured Loans	84.032	125,455,818	A
College Work-Study Program	84.033	9,705,166	
Library Services	84.034	6,634,884	
Interlibrary Cooperation and Resource Sharing	84.035	1,600,779	
National Defense/National Direct/ Perkins Loan Cancellations	84.037	366,764	
Perkins Loans	84.038	1,946,837	
Vocational Education--Basic Grants to States	84.048	60,472,766	A
Vocational Education--Consumer and Homemaking Education	84.049	2,331,027	
Vocational Education--Program Improvement and Supportive Service	84.050	42,613	
Vocational Education--Special Programs for the Disadvantaged	84.052	(7,727)	
Vocational Education--State Councils	84.053	380,971	
Higher Education--Cooperative Education	84.055	24,765	
Pell Grant Program	84.063	74,143,593	B

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
Higher Education--Veterans Education Outreach Program	84.064	31,444
Grants to States for State Student Incentives	84.069	11,191,846
Handicapped Education--Severely Handicapped Program	84.086	346,050
Indian Education--Fellowships for Indian Students	84.087	1,863
Improvement in Local Educational Practice	84.089	(983)
Patricia Roberts Harris Fellowships	84.094	32,029
Rehabilitation Services--Basic Support	84.126	121,773,088 A
Rehabilitation Services--Service Projects	84.128	755,265
Rehabilitation Training	84.129	81,704
Centers for Independent Living	84.132	475,026
Migrant Education--Interstate and Intrastate Coordination Program	84.144	27,927
Transition Program for Refugee Children	84.146	4,944,730
Improving School Programs--State Block Grants	84.151	39,469,255 A
Public Library Construction	84.154	1,447,374
Removal of Architectural Barriers to the Handicapped	84.155	2,997,879
Emergency Immigrant Education	84.162	13,304,920

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
State Grants for Strengthening the Skills of Teachers and Instruction in Mathematics, Science, Foreign Languages, and Computer Learning	84.164	8,674,717
Comprehensive Services for Independent Living	84.169	439,849
Jacob K. Javits Fellowships	84.170	24,900
Handicapped--Preschool Grants	84.173	25,166,452 A
Vocational Education--Community Based Organizations	84.174	470,230
Paul Douglas Teacher Scholarships	84.176	2,016,367
Handicapped Infants and Toddlers	84.181	1,635,395
Robert C. Byrd Honors Scholarships	84.185	804,675
Drug-Free Schools and Communities--State Grants	84.186	16,390,066
Supported Employment Services for Individuals With Severe Handicaps	84.187	3,291,677
Adult Education for the Homeless	84.192	103,754
State Activities- Education of Homeless Children and Youth	84.196	172,907
Other--U.S. Department of Education	84.999	936

Department of Education:

Miscellaneous Grants and Contracts:

Shared Revenue--Flood Control Land	98.002	173,761
U.S. Department of Defense-- Operating Reserve, Guard and Training Facilities	98.008	18,990,747 0

Footnotes are presented on page 325.

<u>Federal Agency/Program Title</u>	<u>Federal Catalog Number</u>	<u>Grant Amounts Received</u>
U.S. Department of Labor--Reed Act--Capital Outlay--Equipment	98.012	2,019,579
U.S. Department of Housing and Urban Development--College Housing Debt Service Government Program	98.013	1,267,074
U.S. Department of Agriculture and Various Other U.S. Departments--Fire Prevention/Suppression Agreements	98.016	27,910,801 A
Miscellaneous Federal Receipts	98.099	(11,090)
Miscellaneous Federal Receipts	98.999	3,309,992
Miscellaneous Uncleared Collections	99.999	<u>1,349,592</u>
Total Grants Received		<u>\$11,715,902,201</u>
Total Grants Audited for the OMB, Circular A-128		<u>\$11,109,658,477</u>

A - The Office of the Auditor General reviewed these grants for fiscal year 1988-89 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, 1988, to December 31, 1989. See Appendix B for a description of these reports.

B - Other independent auditors audited this grant. The grant amount is not included in the amount for total grants audited on this page.

* This amount includes commodities.

** This amount represents the value of the stamps themselves.

WEAKNESSES IN COMPLIANCE WITH FEDERAL REGULATIONS
DISTRIBUTION BY GRANT

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	Weaknesses and Item Numbers ^a	
								Other	
<u>Department of Agriculture</u>									
10.550	Food Distribution	State Department of Education	115	9,16		10			
10.551	Food Stamps	Department of Social Services	194	7,19					
10.553	School Breakfast Program	State Department of Education	115	11,16		8,16			
10.553	School Breakfast Program	Department of the Youth Authority	296						2,3
10.555	National School Lunch Program	State Department of Education	115	11,16		8,16			
10.555	National School Lunch Program	Department of the Youth Authority	296						2,3
10.557	Special Supplemental Food Program for Women, Infants, and Children	Department of Health Services	169	3	15	2,4			1
10.558	Child Care Food Program	State Department of Education	115			16			
10.568	Temporary Emergency Food Assistance (Administrative Costs)	Department of Social Services	194						8
<u>Department of Health and Human Services</u>									
13.633	Special Programs for the Aging--Title III, Part B--Grants for Supportive Services and Senior Centers	Department of Aging	151						1
13.635	Special Programs for the Aging--Title III, Part C--Nutritional Services	Department of Aging	151						1

^a The item number is the number of each weakness as presented in the state agencies' management letters.

Weaknesses and Item Numbers^a

<u>Federal Catalog Number</u>	<u>Grantor Agency/Program Title</u>	<u>Administering State Agency</u>	<u>Page Number</u>	<u>Inadequate/Late Reports</u>	<u>Insufficient Support for Expenditures</u>	<u>Insufficient Monitoring/Auditing</u>	<u>Early Request/Late Disbursement of Federal Funds</u>	<u>Other</u>
13.645	Child Welfare Services State Grants	Department of Social Services	194	7,12				
13.658	Foster Care--Title IV-E	Department of Social Services	194	7,12,19	6	13		
13.714	Medical Assistance Program	Department of Health Services	169			8		7
13.780	Family Support Payments to States--Assistance Payments	Department of Social Services	194	7,19	6	15	4	9,10
13.783	Child Support Enforcement	Department of Social Services	194	7				10
13.786	State Legalization Impact Assistance Grants	Department of Health Services	169		11		12	9,10,12
13.786	State Legalization Impact Assistance Grants	Department of Social Services	194	7,19				19
13.786	State Legalization Impact Assistance Grants	State Department of Education	115					1
13.787	Refugee and Entrant Assistance--State Administered Program	Department of Social Services	194	7,12,14				11,19
13.789	Low-Income Home Energy Assistance	Department of Economic Opportunity	140				1	
13.792	Community Services Block Grant	Department of Economic Opportunity	140				1	
13.802	Social Security--Disability Insurance	Department of Social Services	194	12,19	6,19		5	10,19

^a The item number is the number of each weakness as presented in the state agencies' management letters.

Federal Catalog Number	Grantor Agency/Program Title	Administering State Agency	Page Number	Weaknesses and Item Numbers ^a					
				Inadequate/Late Reports	Insufficient Support for Expenditures	Insufficient Monitoring/Auditing	Early Request/Late Disbursement of Federal Funds	Other	
13.992	Alcohol and Drug Abuse and Mental Health Services Block Grant	Department of Alcohol and Drug Programs	153			1,2,3,4			
13.992	Alcohol and Drug Abuse and Mental Health Services Block Grant	Department of Mental Health	184			1,2			
<u>Department of Labor</u>									
17.225	Unemployment Insurance	Employment Development Department	159	2,3					
17.250	Job Training Partnership Act	Employment Development Department	159	4		5			
17.250	Job Training Partnership Act	State Department of Education	115	13		8			
<u>Department of Transportation</u>									
20.205	Highway Planning and Construction	Department of Transportation	85	3,5				5,7	
<u>Federal Emergency Management Agency</u>									
83.516	Disaster Assistance	Office of Emergency Services	225	3,4,5				1,2	
<u>Department of Education</u>									
84.010	Educationally Deprived Children--Local Educational Agencies	State Department of Education	115			8			
84.011	Migrant Education--Basic State Formula Grant Program	State Department of Education	115			15			
84.027	Handicapped--State Grants	State Department of Education	115		14				

^a The item number is the number of each weakness as presented in the state agencies' management letters.

Weaknesses and Item Numbers^a

<u>Federal Catalog Number</u>	<u>Grantor Agency/Program Title</u>	<u>Administering State Agency</u>	<u>Page Number</u>	<u>Inadequate/Late Reports</u>	<u>Insufficient Support for Expenditures</u>	<u>Insufficient Monitoring/Auditing</u>	<u>Early Request/Late Disbursement of Federal Funds</u>	<u>Other</u>
84.032	Higher Education Act Insured Loans	California Student Aid Commission	110	4				2,3,5,6
84.048	Vocational Education--Basic Grants to States	State Department of Education	115	12,16	7			16
84.048	Vocational Education--Basic Grants to States	California Community Colleges, Chancellor's Office	93	4	2,3		1	
84.049	Vocational Education--Consumer and Homemaking Education ^b	State Department of Education	115		7			
84.126	Rehabilitation Services--Basic Support	Department of Rehabilitation	189	2		1,3		3
84.151	Improving School Programs--State Block Grants	State Department of Education	115			8		
84.186	Drug Free Schools and Communities--State Grants ^b	State Department of Education	115					6
<u>Department of Agriculture</u>								
98.016	Fire Prevention/Suppression Program	Department of Forestry and Fire Protection	239		1			2,3,6
<u>Various Federal Departments</u>								
	Numerous Federal Programs	State Department of Education	115				16	16
	Numerous Federal Programs	Stephen P. Teale Data Center	72					1
	Numerous Federal Programs	Department of General Services	264					1
	Numerous Federal Programs	Health and Welfare Agency Data Center	165					1

^a The item number is the number 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.

SCHEDULE OF AUDIT REPORTS
INVOLVING FEDERAL GRANTS
JULY 1, 1988 TO DECEMBER 31, 1989

From July 1, 1988, to December 31, 1989, 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.

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Report Title and Description</u>
Alameda-Contra Costa Transit District	Urban Mass Transportation Capital Improvement Grants, Urban Mass Transportation Technical Studies Grant, and Urban Mass Transportation Formula Grants 20.500 20.505 20.507	Alameda-Contra Costa Transit District: First through Fifth Quarterly Monitoring Reports (P-861.1, 1-5-89; P-861.2, 4-6-89; P-861.3, 7-7-89; P-861.4, 10-4-89; and P-861.5, 12-20-89) (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, resulting in a balanced budget for fiscal year 1989-90. However, as a result of the earthquake of October 1989, the district substantially increased its bus services and its expenses.
California Community Colleges, Chancellor's Office	Various programs of the State Department of Education and the Department of Health and Human Services	(2) 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. (3) 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. The Chancellor's Office of the California Community Colleges Has Developed Procedures That Result in a Circumvention of Many State Fiscal Controls (P-768, 5-10-89) (1) An employee of the Chancellor's Office of the California Community Colleges (Chancellor's Office) unilaterally instructed three community college districts, which acted as fiscal agents on behalf of the Chancellor's Office, to make over \$821,000 in payments to a consulting firm that allegedly provided no services. In addition, the Chancellor's Office used the Los Rios Foundation as its fiscal agent to collect and disburse over \$124,000 in registration fees from conferences sponsored by the Chancellor's Office.

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Report Title and Description</u>
Criminal Justice Planning, Office of	Crime Victim Assistance and State and Local Narcotics Control Assistance 16.575 16.579	<p>(2) The Chancellor's Office improperly awarded at least 13 consultant contracts worth over \$940,000 to the Community College Foundation.</p> <p>(3) The Chancellor's Office directed its fiscal agents to use a portion of the \$7.3 million in local assistance funds appropriated to one of its programs to pay administrative expenses normally paid from a state department's support budget.</p> <p>(4) The Chancellor's Office sometimes circumvented the civil service system by improperly contracting for services.</p> <p>(5) The Chancellor's Office allowed certain employees to have unilateral discretion over allocations of certain program funds and failed to exert proper supervision.</p>
Education, State Department of	Various Department of Education and Veterans Administration programs	<p>The Office of Criminal Justice Planning Can Improve Its Process for Awarding Grants and Evaluating and Directing Grantee Performance (F-814, 10-5-88)</p> <p>(1) The Office of Criminal Justice Planning (OCJP) allocated approximately \$59.6 million in grants for fiscal year 1987-88 to public and private organizations for the more than 30 programs that the OCJP administers. During our review of 6 programs for which the OCJP allocated approximately \$25.4 million, we noted that the OCJP generally has an appropriate process for awarding grants, but it can make improvements.</p> <p>(2) Further, once it has awarded funding to grantees, the OCJP has not properly evaluated and directed the grantees' performance in many instances.</p> <p>A Review of the State Department of Education's Authorization of Private Postsecondary Educational Institutions (P-869, 11-27-89)</p> <p>(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.</p>

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Report Title and Description</u>
Employment Development Department	Employment Services Unemployment Insurance Job Training Partnership Act 17.207 17.225 17.250	<p>(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.</p> <p>(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.</p> <p>A Review of the Employment Development Department's Acquisition of New Automated Systems and Its Management of Its Programs and Field Offices (P-752, 2-22-89)</p> <p>(1) The Employment Development Department (department) has experienced cost increases and schedule delays in the development of its six automated systems. However, these systems should provide, and some have, improved services to the public or reduced costs to the State.</p> <p>(2) Some parts of the Tax Accounting System (TAS), one of three completed systems, did not operate correctly, resulting in a backlog of the department's daily workload and delayed collection of approximately \$27.4 million in tax revenues.</p> <p>(3) The department has not always issued first payments promptly to all claimants for disability insurance benefits.</p> <p>(4) Although it has been successful at identifying delinquent taxpaying employers, the department could increase the amount of delinquent taxes that it identifies if it uses more staff time in its audit activities.</p>
General Services, Department of--Office of Local Assistance	Asbestos Hazards Abatement (Schools) Assistance 66.702 (The schools receive their federal funds directly from the federal government.)	<p>California Can Improve Its Program To Fund Asbestos Abatement Projects in School Districts (P-773, 8-24-88)</p> <p>(1) The Office of Local Assistance (OLA) of the Department of General Services administers the Asbestos Abatement Fund from which the OLA has disbursed to school districts approximately \$8.6 million of the \$24.75 million that has been appropriated to it since the fund's creation in 1984.</p>

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
		<p>During our review, we noted that the OLA does not promptly process applications from school districts for monies from the Asbestos Abatement Fund. In addition, school districts have been slow in submitting the documentation required to support their applications for asbestos abatement funds. As a result, some school districts have not received available state funds to abate asbestos in their schools.</p>
		<p>(2) The OLA failed to meet a deadline for submitting to the federal government an application for federal funds to inspect for asbestos-containing material and to develop plans for abating this asbestos. As a result, California and its school districts lost the opportunity to compete for up to \$500,000 in federal funds.</p>
Health Services, Department of	State Survey and Certification of Health Care Providers and Suppliers 13.777	<p>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)</p>
		<p>(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.</p>
		<p>(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.</p>
		<p>(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.</p>
		<p>(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.</p>
		<p>(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.</p>

Agency Receiving Federal Funds	Federal Grant and Federal Catalog Number	Report Title and Description
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	<p>The Departments We Reviewed Within the Health and Welfare Agency Are Not Complying With the Direct Service Contract Reforms (F-859, 7-6-89)</p> <p>(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.</p>
Los Angeles County Department of Mental Health	Various programs of the Department of Health and Human Services	<p>A Review of the Los Angeles County Department of Mental Health (P-929, 12-18-89)</p> <p>(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.</p>
Military Department	U.S. Department of Defense-- Operating Reserve, Guard and Training Facilities 98.008	<p>A Review of the California Air National Guard's 144th Fighter Interceptor Wing (P-822, 4-26-89)</p> <p>(1) Because complete records were not available, we could not independently verify the adequacy of the California Air National Guard's 144th Fighter Interceptor Wing's (FIW) aircrew training, aircraft maintenance, or flight safety activities before October 1987.</p> <p>(2) Between October 1987 and January 1989, the FIW managed its aircraft maintenance, aircrew training, and flight safety activities in accordance with Air Force and Air National Guard regulations and directives.</p>

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Report Title and Description</u>
Public Bus Operators	Urban Mass Transportation Capital and Operating Assistance Formula Grants 20.507	<p data-bbox="349 1008 397 1900">A Review of the Public Bus Operations in California (P-777.1, 9-14-89)</p> <p data-bbox="414 1008 544 1900">(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.</p> <p data-bbox="560 1008 690 1900">(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.</p> <p data-bbox="706 1008 836 1900">(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.</p> <p data-bbox="852 1008 950 1900">(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.</p> <p data-bbox="966 1008 1112 1900">(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.</p> <p data-bbox="1128 1008 1242 1900">(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.</p>

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Report Title and Description</u>
Social Services, Department of	Social Services Block Grant 13.667	<p>A Review of California's Contracts for In-Home Supportive Services (P-712, 9-21-88)</p> <p>(1) The State's In-Home Supportive Services (IHSS) program is funded by the federal, state, and county governments. In fiscal year 1987-88, contracts to provide IHSS were worth approximately \$39.7 million, or 9 percent of the total IHSS program expenditures. Counties administer IHSS contracts locally; the Department of Social Services (department) is responsible for the approval and oversight of IHSS contracts statewide.</p> <p>(2) Although most of the contract costs that we analyzed for seven original IHSS contracts and five renewed IHSS contracts were reasonable, neither the department nor the six counties that we reviewed have fully complied with the provisions governing these contracts, nor have they ensured that contract costs are reasonable. As a result, the department and the counties have missed opportunities to reduce the costs of IHSS contracts, and the interests of the State and the counties have not been fully protected.</p>

SCHEDULE OF MINOR FEDERAL ISSUES
FISCAL YEAR ENDED JUNE 30, 1989

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Description of Issue</u>
California Student Aid Commission	Higher Education Act Insured Loans 84.032	<p>(1) The commission did not always report collections of defaulted loans to the federal government within the required 60 days. The commission was late in reporting approximately \$57,000 of \$30.8 million in total collections due to the federal government.</p> <p>(2) The commission did not correctly calculate the federal share of collections on a defaulted student loan. For one of 24 collections that we reviewed, the commission calculated the federal share to be \$8.33 less than the amount to which the federal government was entitled.</p>
Developmental Services, Department of	School Breakfast Program and National School Lunch Program 10.553 10.555	<p>(1) The department made four clerical errors that resulted in charging the federal government incorrectly for 39 meals of 3,733 meals we tested. The federal government was overcharged by approximately \$2 for each meal.</p>
	Medicare Assistance Program 13.714	<p>(1) For 22 (12 percent) of the 180 billings that we tested, the department either under- or over-billed for the services provided to clients at two developmental centers. The financial effect was less than 0.6 percent of the dollar amount tested.</p>
Employment Development Department	Job Training Partnership Act 17.250	<p>(1) The department made a clerical error when preparing its annual expenditure report for summer youth for the period ended September 30, 1989. As a result, the department overstated by approximately \$56,000 the total reported expenditures of approximately \$60 million.</p> <p>(2) The department did not ensure that one of the 33 service delivery areas participating in the program had an independent audit as required.</p>

<u>Agency Receiving Federal Funds</u>	<u>Federal Grant and Federal Catalog Number</u>	<u>Description of Issue</u>
Social Services, Department of	Disaster Assistance 83.516	<p>(1) The department did not attempt to recoup approximately \$12,400 in questioned costs and \$63,300 in unresolved costs identified in the audit of individual family grants for the Northern California Wildfires 1988 Disaster.</p> <p>(2) The department could not locate the documentation to support a \$3,625 individual family grant payment to one of the ten subrecipients that we reviewed.</p>

REPORT ON COMPLIANCE WITH
STATE LAWS AND REGULATIONS



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STATE OF CALIFORNIA
Office of the Auditor General

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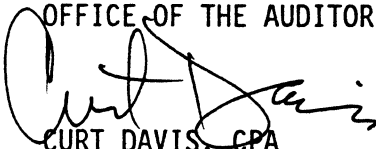
Members of the Joint Legislative Audit Committee
State of California

We have audited the general purpose financial statements of the State of California as of and for the year ended June 30, 1989, and have issued our report thereon dated December 22, 1989. 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 and that we also discuss in pages 65 through 300 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 Joint Legislative Audit Committee, management, and the Legislature of the State of California. 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 23, 1990

SCHEDULE OF ACTUAL AND POTENTIAL LOSSES IDENTIFIED
DURING OUR REVIEW OF THE STATE'S FINANCIAL ACTIVITIES

	<u>Page Number</u>	<u>Lost Interest and Discounts</u>	<u>Amounts Owed to the State for Extended Periods</u>	<u>Unnecessary Expenditures</u>	<u>Lost Revenue</u>
California Community Colleges, Chancellor's Office (Item #12)	93			\$11,841	
California State University (Item #2)	107	\$ 4,300			
California Student Aid Commission (Item #1)	110				\$ 875,000
Economic Opportunity, Department of (Item #2)	140		\$282,194		
Forestry and Fire Protection, Department of (Items #2 and #3)	239	192,800			9,000
Franchise Tax Board (Items #2 and #3)	253			7,400	486,000
Health Services, Department of (Items #5,6,10, and 15)	169	3,418		38,621	80,000
Mental Health, Department of (Item #3)	184	5,700			
Mule Creek State Prison (Item #3)	292	122			
State Personnel Board (Item #2)	280		7,040		
Social Services, Department of (Items #3 and 4)	194	459,000			2,200,000
Transportation, Department of (Item #2)	85	<u>19,000</u>	<u> </u>	<u> </u>	<u> </u>
Total		<u>\$684,340</u>	<u>\$289,234</u>	<u>\$57,862</u>	<u>\$3,650,000</u>

APPENDIX B

**REPORTS ISSUED BY THE
OFFICE OF THE AUDITOR GENERAL
JULY 1, 1988 TO DECEMBER 31, 1989**

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
<u>1988</u>		
Jul 01	State of California Statement of Security Accountability of the State Treasurer's Office June 30, 1987	F-703
Jul 07	The Growth and Costs of California's Independent Study Program	P-755
Jul 20	A Review of the San Juan Suburban Water District's Accounting Controls, Contracting Practices, and Expenditure of Bond Proceeds	F-762
Jul 27	Public Reports of Investigations Completed by the Office of the Auditor General Between January 1, 1988 and June 30, 1988	I-841
Aug 18	California's Regional Centers for the Developmentally Disabled Need Better Financial Controls	P-744
Aug 24	California Can Improve Its Programs To Fund Asbestos Abatement Projects in School Districts	P-773
Aug 25	California's Records on the Incidence of Child Abuse Are Incomplete and Inaccurate	P-739
Aug 31	The State Inappropriately Required the Boys' and Girls' Club of Escondido To Prohibit Its Administrators From Managing Its Child Care	P-763
Sep 21	A Review of California's Contracts for In-Home Supportive Services	P-712

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Oct 05	The Office of Criminal Justice Planning Can Improve Its Process for Awarding Grants and Evaluating and Directing Grantee Performance	F-814
Oct 19	The Department of Health Services Did Not Comply With All Requirements for Awarding and Managing Consultant Contracts	P-753
Nov 09	The Office of State Registrar Promptly and Accurately Responds to Most Requests Regarding the State's Vital Records and Stores the Records Properly	P-748
Nov 28	The California Maritime Academy's Compliance With Recommendations of the Office of the Auditor General (Letter Report to the Joint Legislative Audit Committee (JLAC))	F-848
Nov 28	Information on the Implementation of the Mentally Disordered Offender Program (Letter Report to JLAC)	P-734
<u>1989</u>		
Jan 05	Alameda-Contra Costa Transit District: First Quarterly Monitoring Report	P-861.1
Jan 25	The California Public Utilities Commission Can Improve Its Regulation of Limousine Operators	P-826
Feb 01	An Audit of the California Department of Corrections' Program Management Contractor	P-847.1
Feb 02	A Follow-up Review of the Placement of Delinquent Minors in the VisionQuest Program	P-780
Feb 14	State of California, Financial Report, Year Ended June 30, 1988	F-805
Feb 22	A Review of the Employment Development Department's Acquisition of New Automated Systems and Its Management of Its Programs and Field Offices	P-752

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Mar 02	A Review of the State's Progress in Improving Controls Over Its Financial Operations	F-800
Apr 05	A Review of the Workers' Compensation System	P-830
Apr 06	Alameda-Contra Costa Transit District: Second Quarterly Monitoring Report	P-861.2
Apr 12	An Audit of the California Department of Corrections' Construction of the San Diego Prison	P-847.2
Apr 17	The California Exposition and State Fair Is Fiscally Independent but Can Still Improve Its Financial Condition and Management Controls	F-828
Apr 26	A Review of the California Air National Guard's 144th Fighter Interceptor Wing	P-822
May 10	The Chancellor's Office of the California Community Colleges Has Developed Procedures That Result in a Circumvention of Many State Fiscal Controls	P-768
May 11	The State Department of Education's Implementation of Programs Mandated by Chapter 1431, Statutes of 1985 (Senate Bill 65) (Letter Report to JLAC)	P-870.1
May 17	The San Francisco Bay Area Rapid Transit District Complied With Its Procedures and Requirements in Awarding Its Contract for Express Bus Services	P-777.2
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

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Aug 14	A Review of the Riverside County Department of Mental Health's Contracts With the Harvest of Wellness Foundation (Letter Report to JLAC)	P-874
Aug 21	An Estimate of Oakland Unified School District's Current and Future Financial Condition (Letter Report to JLAC)	F-931
Aug 28	A Review of the Operations and Funding of the California Relay Service (Letter Report to JLAC)	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
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 to JLAC)	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 4	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 to JLAC)	P-869
Dec 6	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 to JLAC)	P-929

<u>DATE OF ISSUE</u>	<u>REPORT TITLE</u>	<u>REPORT NO.</u>
Dec 20	Alameda-Contra Costa Transit District: Fifth Quarterly Monitoring Report	P-861.5

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR

March 16, 1990

Kurt R. Sjoberg
Acting Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

REPORT F-904--A REVIEW OF THE STATE'S PROGRESS IN IMPROVING 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, 1989. 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 1988-89.

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 but some still remain. We appreciate the concerns expressed in the identification of actual and 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.

The following is our response to each of the statewide concerns that you've identified in your draft:

. INCONSISTENT FINANCIAL REPORTING

We are addressing the issue of Generally Accepted Accounting Principles (GAAP) in several areas, including budget preparation and state agency reporting. The Governor's Budget for 1989-90 was changed to reflect GAAP treatment of encumbrances and continuing appropriations. Further, as your report points out, the Governor's Budget for 1990-91 includes a proposal to change the method of reporting outstanding purchase orders and contracts to more closely conform to GAAP. However, because of the complexity of the State's budgeting and reporting system we are progressing cautiously in order to assure that the necessary changes to be made are in the best interests of the State.

. PROBLEMS WITH THE STATE'S CONVERSION TO GAAP

The State of California is in the process of converting to GAAP where it is practical. Some changes will require legislation before conformance to GAAP can be attained. In accordance with Chapter 1286, Statutes of 1984 (AB 3372), the Department of Finance is charged with implementing these changes to the extent that the changes are in the best interests of the State.

There are some areas of GAAP where the proper accounting treatment is not defined or is extremely impractical and costly. For example, the proper accounting treatment of continuing appropriations is subject to interpretation with no clear direction from GAAP. Other areas, such as accounting for vacation accruals, require the establishment of very expensive record systems which do not aid in the effective administration of the State. Consequently, we are proceeding cautiously in a number of GAAP areas. However, there are changes that we have made including bringing the State's "Fund Manual" into conformance with GAAP. Further, the General Fund encumbrances are now treated as a reservation of fund balance, as GAAP requires. Finally, the State has revised some parts of its State Administrative Manual related to proprietary funds to bring them into conformance with GAAP.

. FAILURE OF THE DEPARTMENT OF FINANCE TO ENSURE THAT THE CHARGES OF INTERNAL SERVICE FUNDS TO FEDERAL PROGRAMS ARE IN COMPLIANCE WITH FEDERAL REGULATIONS.

We are concerned that the State comply with all federal regulations. However, we feel that to some extent the issue of "profits" in internal service funds has occurred because the federal government has been unwilling to recognize states' needs for a reasonable working capital reserve, which we feel should be 90 days. The federal Office of Management and Budget has proposed an amendment allowing a reserve of 60 days. Once the issue of working balance is resolved, the Department of Finance plans to address the issue of setting rates for internal service funds.

. INADEQUATE ACCOUNTABILITY OVER PAYMENTS OF STATE FUNDS BY FISCAL AGENTS

Although the State Administrative Manual is silent regarding contracts with fiscal agents, it does provide procedures for contracts in general. Therefore, the approval of fiscal agent contracts is subject to the State's contracting procedures. However, we share your concern about the lack of review by the various state control agencies of payments made by these fiscal agents. We will be reviewing the State Administrative Manual to consider your recommendation.

. DELAYS IN PRODUCING AUDITED FINANCIAL STATEMENTS

The State is endeavoring to reduce the time required to prepare and submit the year-end statements to the State Controller 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. To this end, the State colleges and universities are part of a pilot project to prepare an automated report to replace a number of standard reports.

. LACK OF COMBINING STATEMENTS BY FUND TYPE

The Office of the State Controller 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.

. INSUFFICIENT ACCOUNTABILITY FOR FIXED ASSETS

The Department of General Services, as part of the State's Fixed Asset Task Force, estimates completion of the state-wide inventory of major fixed assets by June 1990. Further, a new report, Statement of General Fixed Assets, requires agencies to report acquisitions and dispositions of general fixed assets.

. INELIGIBILITY FOR CERTIFICATE OF ACHIEVEMENT

As we have previously stated, we recognize the desirability of qualifying California for the Certificate of Achievement for Excellence in Financial Reporting. Consequently, we have 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.

. FRAUD AND EMBEZZLEMENT CAN OCCUR DUE TO INADEQUATE CONTROL OVER 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, after we complete our investigation of the specific fraud cited in your report, we will consider what changes are necessary to prevent further occurrences.

. 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.

. IMPROPER OMISSIONS FROM THE STATE REPORTING PROCESS


We will ask for a determination from the State's legal counsel and move toward implementation of that opinion as to the appropriateness 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

Since the solution to these two findings requires preparation and submission of statements not now required, it must be coordinated with the problem of timely submission of year-end statements, noted above. We will include the effect of new statements in the review of the necessity of preparation of all existing statements. Presently, the Department of Finance is reviewing a request from the State Controller to require agencies accounting for Non-Governmental Cost Funds to submit a complete set of reports including a Report of Accruals.

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.

Very truly yours,


JESSE R. HUFF
Director of Finance

cc: Curt I. Davis, CPA
Deputy Auditor General

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps