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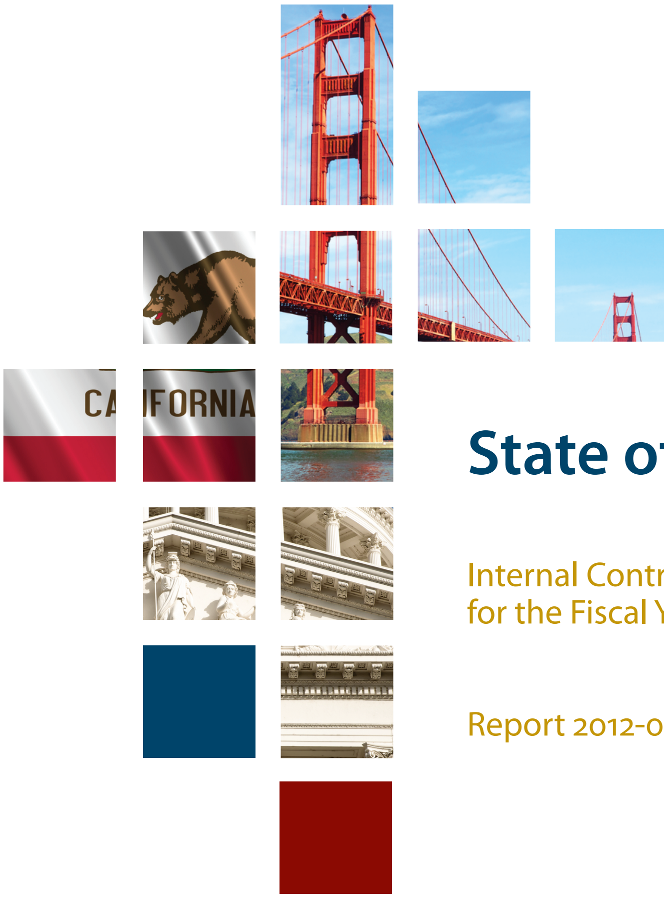

State of California

Internal Control and Compliance Audit Report for the Fiscal Year Ended June 30, 2012

Report 2012-001.1

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March 26, 2013 2012-001.1

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

Dear Governor and Legislative Leaders:

As required by California Government Code, Section 8543 et seq., the California State Auditor presents this audit report concerning our review of the State of California's internal controls and compliance with state laws and regulations for the year ended June 30, 2012.

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

Respectfully submitted,

John F. Collins II

JOHN F. COLLINS II, CPA
Deputy State Auditor

Contents

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

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

The Governor and the Legislature of the State of California

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California as of and for the year ended June 30, 2012, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated March 15, 2013. Our report includes a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. As described in our report on the State of California's financial statements, other auditors audited the financial statements of the following:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 87 percent and 38 percent, respectively, of the assets and revenues of the business-type activities.

- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, State Lottery fund, and California State University fund.

- Certain nonmajor enterprise funds that represent 92 percent and 75 percent, respectively, of the assets and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System, and certain other funds that, in the aggregate, represent 89 percent and 44 percent, respectively, of the assets and additions of the fiduciary funds and similar component units.

- The discretely presented component units noted above.

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

Management of the State of California is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the State of California's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of California's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of California's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies, or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying Schedule of Findings, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies. .

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be material weaknesses—items 2012-3 and 2012-4.

A significant deficiency is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be a significant deficiency—item 2012-2

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of California's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. It is presented in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as item 2012-1.

The State of California's response to the findings identified in our audit are described in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. We did not audit the State of California's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the governor, the Legislature, and the management of the executive branch of the State of California, and is not intended to be and should not be used by anyone other than these specified parties.

CALIFORNIA STATE AUDITOR

John F. Collins II

JOHN F. COLLINS II, CPA
Deputy State Auditor

March 15, 2013

Schedule of Findings

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STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2012

Summary of Auditor's Results

Financial Statements

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

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

CALIFORNIA COMMUNITY COLLEGES CHANCELLOR'S OFFICE

Reference Number: 2012-1

Condition

The California Community Colleges Chancellor's Office (Chancellor's Office) authorized $3 million in general apportionments to three community college districts that were not entitled to receive such amounts in fiscal year 2011–12. Further, the Chancellor's Office has authorized $48.5 million of such payments to these same districts since fiscal year 2005–06, without explicit legal authority. The Chancellor's Office payment to these districts in fiscal year 2011–12 amounted to approximately half of the $5.9 million it paid to them in fiscal year 2010–11, when we first reported a finding on this issue.

Community college districts receive apportionment funding primarily from three sources: property taxes, student fees, and the State's General Fund. Where local property taxes and student fees alone do not meet a district's apportionment target, the General Fund provides additional funding, referred to as general apportionments, to each district. The Chancellor's Office calculates each district's general apportionment annually based on criteria set forth in Education Code sections 84750.5 through 84751.5, including data on student enrollment and local revenues. Districts that have local property tax and student fee revenues that exceed their apportionment target are not entitled by law to receive general apportionment funding from the State. These districts are known as excess tax school entities, or basic aid districts.

Last year, the director of Fiscal Services of the Chancellor's Office (director) stated that, between fiscal years 2005–06 and 2010–11, revenues for three of the State's 72 community college districts—Mira Costa, Marin, and South Orange—exceeded their apportionment target. This continued to be the case in fiscal year 2011–12. However, while these districts did not meet the criteria set forth in Education Code sections 84750.5 through 84751.5 to receive general apportionment funding, the Chancellor's Office authorized such funding for each of the last seven years. Annually, these amounts ranged from $3 to $8.7 million between fiscal years 2005–06 and 2011–12.

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

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

Criteria

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

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

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

Recommendations

To ensure that community college districts that rely on general apportionment funding receive their entitled amounts, the Chancellor's Office should do the following:

- Discontinue distributing general apportionment funding to districts that do not meet the criteria set forth in the Education Code for receiving general apportionment funding, also known as basic aid districts.
- Recover $48.5 million in general apportionments paid to the Mira Costa, Marin, and South Orange community college districts, and redistribute these monies to the remaining community college districts.

Department's View and Corrective Action Plan

The Chancellor's Office agrees that these payments should not be continued. To this end, we have phased out the PFE payments to the three basic aid districts. For the 2011–12 fiscal year, these districts received one-half of the value of the PFE payment and will not receive any PFE funding in 2012–13 or any fiscal year thereafter.

We disagree, however, that the prior payments should be recovered from the districts. We believe that the prior payments were made due to a reasonable interpretation of the situation for the following reasons:

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

The Chancellor's Office interpreted the continuation of funding as intent to continue the funding for all districts, including basic aid districts.

When the Legislative Analyst's Office brought the PFE funding of basic aid districts to the attention of the Legislature in the spring of 2011, legislative staff communicated to the Chancellor's Office an inclination to discontinue the payments to basic aid districts. This led to a reexamination of the practice and the corrective action as previously described.

We believe it would be a hardship on the Mira Costa, Marin and South Orange Community College Districts to be compelled to repay funds allocated over a number of prior years due to a revision in understanding of legislative intent concerning the issue. We believe our solution to deal with the issue prospectively represents a satisfactory corrective action.

DEPARTMENT OF GENERAL SERVICES

Finding Number: 2012-2

Condition

In fiscal years 2010–11 and 2011–12, a number of state agencies improperly accounted for about $112 million of new capital assets whose construction was administered by the Department of General Services (General Services). The Architecture Revolving Fund—managed by General Services—funds the construction, repair, and improvement of state buildings. General Services tracks expenditures in the fund and is responsible for notifying the agency receiving the asset (client agency) when the project is complete so that the client agency can record the asset. Additionally, General Services' statewide real property inventory—a detailed inventory of state properties including land and buildings—is incomplete. Agencies are to use this inventory in performing required annual reconciliations of their capital assets.

General Services currently has processes in place for notifying client agencies when constructed assets are complete and for recording these assets in its statewide property inventory. However, client agencies are not always properly recording these assets after General Services sends them notices of asset completion. Specifically, for fiscal years 2010–11 and 2011–12, our testing of 10 completed projects found that in six cases client agencies either did not record the assets or accounted for them incorrectly. The client agencies we reviewed provided various explanations for why they had not properly accounted for completed assets. For example, one client agency stated it had not received a notice from General Services that its project was complete. However, General Services' records show that notice was sent to the client agency within a month after the project's completion. In another instance, a client agency said that due to the implementation of a new accounting system and a change in staff, it did not record an asset when it received notice from General Services. Finally, in another case, a client agency was notified the project was complete, but it incorrectly expensed the related costs rather than recording them as a capital asset. In addition, we found that General Services does not follow up with client agencies after it notifies them that a project is complete.

Further, agencies that do not properly account for completed assets may have difficulty identifying errors because General Services is not always properly maintaining its property inventory. A limited review showed the statewide property inventory to be incomplete. We were able to locate only two of the 10 tested projects noted above on General Services' list. Further, the dollar amounts in the statewide inventory database for these two items did not agree with those in General Services' notices. We were unable to locate the other eight projects in the inventory although it is possible that they are combined with other projects. A manager from the statewide property inventory unit agreed that the database is incomplete and said that General Services is currently working on new procedures for updating the inventory. Since General Services is responsible for notifying client agencies when capital projects are complete and for updating the statewide property inventory, we would expect General Services to work closely with the client agencies to ensure they are properly recording completed assets.

When agencies submit inaccurate or incomplete statements of changes in capital assets to the State Controller's Office (Controller), the Controller cannot report accurate information on the value of capital assets in the State's Comprehensive Annual Financial Report. Our testing performed in fiscal years 2010–11 and 2011–12 found that, respectively, $49 million and $63 million worth of capital assets for which General Services sent notices of completion to client agencies were not reported by client agencies and thus were omitted from the capital assets reported by the Controller. Over time, these errors could become significant if not corrected.

Criteria

When a capital project is complete, state law requires General Services to return any remaining project funds from the Architecture Revolving Fund to the client agency. General Services accomplishes this through a Request for Funds Transfer, which notifies client agencies of project completion, actual project cost, and any amount to be returned. The *State Administrative Manual* requires state agencies to report additions and deletions of capital assets to the Controller in a statement of changes in capital assets at the end of each fiscal year.

State law requires General Services to maintain a complete and accurate statewide inventory of all real property held by the State and to categorize that inventory by agency and geographical location. The inventory is to include all information furnished by agencies. This information is to include the date of acquisition and purchase price, if available. In addition, the *State Administrative Manual* instructs agencies to annually reconcile their record of capital assets to General Services' statewide inventory.

Recommendations

To ensure that the capital assets it constructs are properly recorded by client agencies upon completion, General Services should develop a process for following up with client agencies to verify that they have accurately recorded the projects.

General Services should ensure that its statewide property inventory is complete and contains accurate information on asset values in order to facilitate required reconciliations by state agencies and the verification of proper capital asset reporting.

Department's View and Corrective Action Plan

Each state agency is ultimately responsible and accountable for maintaining complete and accurate records of its capital assets. To assist state agencies in meeting this responsibility, the DGS will develop a process to remind state agencies to accurately record Architecture Revolving Fund (ARF) projects upon completion.

In addition, within the next sixty-days, the DGS will develop additional policies and procedures to ensure that ARF projects are recorded in a complete and accurate manner in the Statewide Property Inventory.

DEPARTMENT OF HEALTH CARE SERVICES
STATE CONTROLLER'S OFFICE

Reference Number: 2012-3

Condition

The Department of Health Care Services (DHCS) understated Medi-Cal expenditures for fiscal year 2011–12 for the Hospital Quality Assurance Revenue Fund and the Public Hospital Investment, Improvement, and Incentive Fund by $3.2 billion and $188 million, respectively. It also overstated Medi-Cal expenditures for the State's General Fund and Federal Trust Fund by $241 million and $1.6 billion, respectively. Additionally, DHCS understated Medi-Cal revenues for these funds by $1.8 billion, combined.

For budgetary purposes, DHCS reports Medi-Cal expenditures on a cash basis. Generally accepted accounting principles (GAAP), however, require governmental funds to be accounted for on a modified accrual basis. Specifically, expenditures should be recognized in the accounting period in which they are incurred. In order to comply with GAAP, DHCS should accrue program expenditures for services provided but not yet paid by June 30.

Omitted Medi-Cal Expenditure and Revenue Accruals

DHCS did not accrue $3.2 billion in expenditures and $1.7 billion in hospital fee revenues for the Hospital Quality Assurance Revenue Fund related to the Hospital Quality Assurance Fee – Hospital Payments program (Hospital Payment program) and the Hospital Quality Assurance Fee – Children's Healthcare program. Welfare and Institutions Code Section 14169.32 imposes a quality assurance fee on hospitals in order to obtain additional federal funding for supplemental payments to hospitals and for payments for children's health care costs. For the Hospital Payment program, DHCS collects quality assurance fees from hospitals, matches these fees to federal funding for the program, and then disburses both quality assurance fee revenues and federal funding back to hospitals as Medi-Cal payments. Nevertheless, DHCS did not accrue $1.7 billion in hospital fee revenues and corresponding expenditures related to the Hospital Payments and the Children's Healthcare programs. Moreover, it incorrectly accrued $1.5 billion of Hospital Payment program costs as Federal Trust Fund expenditures rather than as Hospital Quality Assurance Revenue Fund expenditures. While a portion of the program's costs are funded with federal funds, DHCS transfers these funds from the Federal Trust Fund to the Hospital Quality Assurance Revenue Fund, which incurs the expenditures. DHCS also did not accrue $188 million in expenditures and related revenues for the Delivery System Reform Incentive Pool (Incentive Pool) program in the Public Hospital Investment, Improvement, and Incentive Fund. This is another fund that receives payments from hospitals to match against federal funding.

According to the General Ledger Unit manager of DHCS's Accounting Section, who is responsible for the Medi-Cal accrual, DHCS did not accrue the Hospital Quality Assurance Fee revenues or expenditures because it did not consider quality assurance fees to be state monies for the purposes of financial reporting. However, because state law imposes the quality assurance fees, they are considered special revenues of the State and are therefore state monies. She also stated that DHCS only accrues General Fund and Federal Trust Fund expenditures as a part of its normal financial reporting process. For the same reasons, she said DHCS did not accrue revenues or expenditures for the Incentive Pool program. However, GAAP require the use of the modified accrual basis of accounting for all governmental funds and as such DHCS should accrue expenditures and related revenues for the Hospital Quality Assurance Revenue Fund and the Public Hospital Investment, Improvement, and Incentive Fund. By not accruing Medi-Cal expenditures and related revenues for funds other than the General Fund and the Federal Trust Fund, DHCS risks materially misstating the Medi-Cal expenditures and revenues it reports.

Understated Medi-Cal Expenditure Accruals

In addition, DHCS understated expenditures and related revenues by $603 million in the Federal Trust Fund for the Specialty Mental Health Consolidation program (Mental Health program), which provides specialty mental health services for Medi-Cal recipients that meet medical necessity criteria. The now defunct Department of Mental Health (DMH) administered the Mental Health program through June 30, 2012. DMH was dissolved and the Department of State Hospitals (State Hospitals) assumed some of its functions; however, DHCS assumed administration of the Mental Health program as of July 1, 2012, in accordance with Chapter 29, Statutes of 2011. For fiscal year 2011–12, DHCS accrued $22.6 million for administration expenditures and $6 million for Mental Health program services based on information provided by State Hospitals. In the prior year, the Mental Health program accruals totaled $999 million. We asked both State Hospitals and DHCS why the expenditure accrual for the Mental Health program was so small. A State Hospitals accounting administrator said that State Hospitals did not accrue more Mental Health program expenditures because it was not responsible for paying program claims after June 30, 2012, and the $6 million accrual only represented expenditures related to audit settlements.

DHCS's General Ledger Unit manager stated that DHCS reported the $6 million accrual prepared by State Hospitals because DHCS did not become the administrator of the Mental Health program until July 1, 2012, and DMH had agreed to prepare the accrual for the Mental Health program in a meeting between DHCS, DMH, and the State Controller's Office (Controller) in February 2012. She also said that after receiving the accrual, DHCS asked State Hospitals about it and was told that the accrual was prepared in the same way as in the past and was supported by accounting reports. However, in incorporating the Mental Health program accrual into the overall Medi-Cal accrual it submitted to the Controller in September 2012, DHCS did not consider the amount of Mental Health program services provided by the end of fiscal year 2011–12 that it assumed responsibility for paying after June 30, 2012. In early December 2012, the General Ledger Unit manager revised the Mental Health program accrual to include these expenditures. DHCS management for the Mental Health program provided us with support for $631.2 million in Mental Health program benefit and administrative services rendered by June 30, 2012. The Mental Health program expenditure accrual was adjusted accordingly.

Additionally, the Controller lacks a robust process to ensure Medi-Cal accruals are complete and accurate. Specifically, the Controller requests high-level information from DHCS related to Medi-Cal accruals by fund, but does not obtain detailed accrual information by program. Given the size of the Medi-Cal accrual and the many programs contained within it, a more detailed review is necessary to identify potentially incomplete or inaccurate accruals. Despite the large drop in the Mental Health program accrual between fiscal years 2010–11 and 2011–12, the Controller only contacted DHCS and requested that it recalculate and resubmit the Mental Health program accrual after we notified the Controller that the accrual was incomplete. Without closer scrutiny by the Controller of the Medi-Cal accrual, the State risks future material misstatements of Medi-Cal expenditures.

Overstated Medi-Cal Expenditure Accruals

DHCS also overstated Medi-Cal Managed Care (MMC) and Medi-Cal Administrative Activities (MAA) expenditures by $472 million and $344 million, respectively. As Table 1 shows, the MMC errors affected both the General Fund and Federal Trust Fund while the MAA errors only affected the Federal Trust Fund. The MMC program provides Medi-Cal services through county-based and commercial health plans. DHCS initially accrued $1.2 billion in MMC expenditures, an overstatement of $472 million. According to the section chief of the Medi-Cal Managed Care Division's (MMCD) Capitation Payment Unit (section chief), the overstatement in expenditures mainly resulted from the double counting of some program costs, the overestimation of certain program expenditures, and the accrual of payments for services rendered after fiscal year-end. The section chief further stated that payment unit management did not review the accrual before submitting it to DHCS's General Ledger Unit. The General Ledger Unit manager stated that she reviewed the Managed Care accrual worksheet submitted by MMCD for mathematical accuracy, but did not review the underlying support as she relies on MMCD management to ensure the accuracy and completeness of the MMC accrual.

Additionally, DHCS overstated its MAA program expenditure accrual by $344 million due to an accrual methodology that was not appropriate for this program. The MAA program provides Medi-Cal outreach, enrollment, and transportation services. According to the chief of the Administrative Claiming, Local and School Services Branch (Administrative Claiming chief), the $550 million MAA accrual was based on the fiscal year-end balance of MAA contracts between DHCS and the counties. However, we reviewed MAA expenditure data from fiscal years 2005–06 through 2011–12 and found that actual annual MAA expenditures ranged between a low of $139 million in fiscal year 2005–06 and a high of $284 million in fiscal year 2007–08.

According to the Administrative Claiming chief, the DHCS Accounting Section required MAA program management to prepare the accrual beginning in fiscal year 2011–12 and the program manager that prepared the accrual was initially unclear about what the accrual should represent. She confirmed that the program manager sought clarification from the DHCS Accounting Section on what an accrual represents and how it should be prepared; however, the resulting accrual indicates a breakdown in DHCS's process. After we discussed what an accrual should represent with members of MAA program management, a program manager created a revised accrual of $206 million based on a methodology using historical MAA claims data, adjusted for the current period. We reviewed both the revised methodology and accrual and found them to be reasonable. Without adequate guidance in how to prepare accruals, DHCS's program managers are at risk of materially misstating expenditures in the future.

As shown in Table 1, smaller errors in accruals for Other Administration and Medicare Parts A and B added $54 million and $159 million to the General Fund and Federal Trust Fund overstatements, respectively. Further, the accrual related to drug rebates understated expenditures of the General Fund by $49 million.

Table 1
Medi-Cal Expenditure Accrual Errors
General Fund and Federal Trust Fund
Fiscal Year 2011–12
(In Millions)

PROGRAM	GENERAL FUND	FEDERAL TRUST FUND	TOTAL
Hospital Payment Program		$1,488	$1,488
Mental Health Program		(603)	(603)
Medi-Cal Managed Care	$236	236	472
Medi-Cal Administrative Activities		344	344
Other Administration		112	112
Medicare Parts A and B	54	47	101
Drug Rebates	(49)		(49)
Totals	**$241**	**$1,624**	**$1,865**

Source: Auditor analysis of the Department of Health Care Services' Medi-Cal accruals for fiscal year 2011–12.

Note: Negative amounts represent understatements and positive amounts represent overstatements.

Criteria

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

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

Recommendations

To ensure its financial statements are properly presented at fiscal year-end, DHCS should report activity for all the governmental funds it manages on a modified accrual basis.

To ensure Medi-Cal expenditure and revenue accruals are properly reported, DHCS should do the following:

- Provide adequate guidance to program management and staff involved in preparing accruals.
- Ensure that accruals and supporting documentation are reviewed for accuracy.
- Review the overall Medi-Cal accrual to determine whether it is materially complete before submission to the Controller.

To ensure the Controller's annual financial report is complete and accurate, when requesting year-end financial statements from DHCS, the Controller should require DHCS to provide detailed accrual information by Medi-Cal program and develop a process to review this information for potential errors.

Department Views and Corrective Action Plans

Department of Health Care Services response:

Recommendation 1: DHCS agrees, for GAAP reporting purposes, accruals will be prepared on all governmental funds where DHCS is the fund administrator. DHCS has accounted for all funds and there was no misdirection of funds.

DHCS has historically budgeted on a cash basis of accounting (i.e., recognition of revenue when received and recognition of expenses when they are paid). DHCS has reported fund activity (such as the Hospital Quality Fee and other special funds) on a cash basis. The California State Auditor's Office (State Auditor) requests the funding to be reported on a modified accrual basis of accounting (i.e. requiring revenues and expenses to be recorded when earned and incurred regardless of time cash is exchanged i.e. received or paid) for year-end reporting purposes only.

DHCS did not accrue the Hospital Quality Assurance Fee revenues or expenditures because the historical method appeared acceptable in previous audits. DHCS will comply with the audit recommendation by providing additional guidance to staff in preparing year-end accruals and performing a thorough review of all funds to ensure the appropriateness of year-end accruals.

Recommendation 2: DHCS agrees with the recommendation. The State Auditor has instructed DHCS to accrue funds that historically were accounted for on a cash basis. DHCS will comply with the State Auditor's request. DHCS Accounting will provide additional guidance to program management and staff involved in preparing accruals in accordance with GAAP in the United States.

Recommendation 3: DHCS Accounting will meet with each program area to review: the approach, methodology, comparison of the prior year to current year accruals, analysis of variances and discuss major changes, review the supporting documentation for mathematical accuracy and completeness.

Recommendation 4: DHCS agrees with the recommendation. DHCS will review the overall Medi-Cal accrual to assure it is materially complete before submission to the Controller. DHCS will expand its current process of reaching out to departmental programs and other State agencies for Medi-Cal related accruals.

DHCS will do a thorough review of all funds to determine the appropriateness of an expenditure or revenue accrual based on the audit principal's recommendation to accrue if federal approval is "likely within one year."

Auditor's Comments on DHCS's View

The Government Accounting Standards Board established the requirement that governmental funds be reported on a modified accrual basis and for many years the Controller has directed departments to accrue governmental fund expenditures and revenues accordingly. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. The Hospital Quality Assurance Revenue Fund was established under a law that became effective in January 2010. We have not previously given DHCS comments related to Medi-Cal accruals for this fund. We, however, note that in fiscal year 2010–11 federal funding was appropriately matched with hospital fees for the fund; such matching did not happen for the fiscal year 2011–12 accrual of federal funds, as described in the finding above. In addition, DHCS has confused two concepts related to modified accrual accounting. We explained to DHCS that revenues should be accrued if payments are expected to be received within 12 months of fiscal-year end. However, we also explained that the revenue must be earned as well. In the context of federal funding, this means that DHCS must ensure it has received federal approval and that services have been provided by the end of the reporting period.

State Controller's Office response:

The SCO will further enhance its current review process by requesting that DHCS provide more detailed explanations and documentation supporting its Medi-Cal program accruals, including explanations of year-to-year variances in its accruals. This change will be included as part of an "extended" reporting package that we will immediately establish for DHCS. Note, however, DHCS—as is the case for all reporting agencies—is ultimately responsible for ensuring that its accrual information is complete and accurate. The SCO review should not be expected to determine the underlying reason or cause for any found variances, or to identify all potential errors for the following reasons:

- Because the information submitted by agencies and relied upon by the SCO is unaudited, each reporting agency is responsible for ensuring that its submitted data is reliable. To underscore the care and attention that must be exercised in their report preparation, this office requires that reporting agencies certify under penalty of perjury that their reporting submissions are complete and accurate.

- In accordance with public accounting standards prescribed by the Governmental Accounting Standards Board (GASB), GASB Statement No. 34, our office prepares the State's financial statements and conducts our analysis at the "fund" level. Your recommendation suggests that we review these two funds, the General Fund and Federal Trust Fund, at the "program" level. The SCO will attempt to absorb the workload costs associated with this deeper dive, but may have to seek additional budget resources later should the effort be found to exceed our current capacity.

Finally, this appears to be an isolated reporting error by DHCS that occurred during the handoff of operational responsibilities between DMH and DHCS. This particular transitional activity was not done effectively, nor in compliance with the plan developed in February 2012, when the SCO met with these two agencies to provide guidance.

Auditor's Comments on the Controller's View

We recommended that the Controller review DHCS's submission at the program level because of the significance of the Medi-Cal accruals. As described above, DHCS made numerous and substantial errors in these accruals. This situation indicates a heightening of the State's risk of material misstatement related to DHCS's Medi-Cal accruals in general and calls for enhanced due diligence on the part of the Controller.

EMPLOYMENT DEVELOPMENT DEPARTMENT

Finding Number: 2012-4

Condition

The Employment Development Department (EDD) made significant errors in reporting fiscal year 2011–12 revenues for its Unemployment Insurance (UI) and Disability Insurance (DI) funds, and related accounts receivable balances at June 30, 2012. EDD estimated and recorded $155 million and $56 million in revenues for UI and DI respectively that it earned in fiscal year 2011–12 and expected to collect in fiscal year 2012–13. However, EDD's calculation of this estimate was based on an incomplete methodology that only captured the portion of earned but uncollected revenues that it billed to employers. It omitted earned but unbilled revenues that could be reasonably estimated. In fact, EDD's accounting records supported its ability to collect about $704 million and $163 million of such unbilled revenues for UI and DI, respectively. These unbilled revenues comprised about 4 percent of total UI revenues of $16.4 billion and 3 percent of total DI revenues of $5.8 billion, respectively, reported by EDD for fiscal year 2011–12. When we brought these errors to EDD's attention, it revised its estimates and submitted adjusting entries to the State Controller's Office (Controller) to correct the UI and DI revenue and accounts receivable balances it previously reported.

In addition, because in prior years EDD failed to record estimates for unbilled revenues, its beginning net deficit at July 1, 2011, was overstated by $890 million and its fiscal year 2011–12 revenues were overstated by the same amount. To correct the errors related to recording revenues in current and prior years, EDD submitted an adjusting entry to the Controller that decreased the beginning deficit for Unemployment Programs at July 1, 2011, from $6.9 billion to $6 billion, and decreased fiscal year 2011–12 revenues by $890 million.

Criteria

Generally accepted accounting principles (GAAP) require that funds using the accrual basis of accounting, such as the UI and DI funds, record revenues in the accounting period in which underlying transactions, events, and circumstances occur rather than in the periods in which cash is received. In addition, receivables are to be reported at the same time that revenues are recognized.

State Administrative Manual, Section 10500 requires that departments accrue revenue earned but not received as of fiscal-year end, if this revenue is estimated to be collectible within one year after the fiscal-year end.

Recommendations

EDD should develop and implement an estimation methodology to calculate the amount of revenues that it has earned during the fiscal year and expects to collect within one year after fiscal-year end. EDD should report this amount as revenues and associated accounts receivable as of the fiscal-year end.

Department's View and Corrective Action Plan

The EDD agrees that errors were reported in fiscal year 2011–12 revenues for its UI and DI funds, and related accounts receivable balances at June 30, 2012. Having implemented its Automated Collection Enhancement System (ACES), EDD can now provide more accurate accrual estimates of revenue earned during the fiscal year and expected to be collected within one year after the fiscal-year end. In the past, EDD only utilized an approach that took five years of historical collection data and estimated the Indirect Revenue portion of the accruals based on the Accounts Receivable as of June 30th. EDD has now supplemented that approach with estimates of unbilled revenues (an estimate of the Direct Revenue portion of the accruals) for the 2nd quarter by employing a methodology using historical data available from ACES and employment wage information available from the Fiscal Programs Division.

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
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