

# California State Auditor

B U R E A U O F S T A T E A U D I T S

## Department of Rehabilitation:

*The Business Enterprise Program for  
the Blind Is Financially Sound, but  
Opportunities for Improvement Exist*

January 1999  
98020

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# CALIFORNIA STATE AUDITOR

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STATE AUDITOR

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January 26, 1999

98020

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 the California Welfare and Institutions Code, Section 19640.5, the Bureau of State Audits presents its audit report concerning its fiscal audit of the Department of Rehabilitation's (department) Business Enterprise Program for the Blind (program). This report concludes that the financial condition of the program is sound, and although the department has improved its financial management of the program, some opportunities for further improvement exist. Specifically, the surplus in the Vending Stand Account—Special Deposit Fund appears excessive. Additionally, the department could increase vending machine income more than 35 percent by establishing contracts for all vending machines on state and federal property.

Respectfully submitted,

A handwritten signature in cursive script that reads "Kurt R. Sjoberg".

KURT R. SJOBERG  
State Auditor

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# SUMMARY

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## Audit Highlights . . .

*The Business Enterprise Program for the Blind is financially sound. However, the following issues need attention:*

- ✓ *The Vending Stand Account—Special Deposit Fund's surplus appears excessive.*
  - ✓ *The Vending Machine Trust Fund's commission income can increase more than 35 percent if the Department of Rehabilitation establishes contracts for all vending machines on state and federal property.*
- 

## RESULTS IN BRIEF

**T**he federal Randolph-Sheppard Act and the California Welfare and Institutions Code govern how the Department of Rehabilitation (department) administers the Business Enterprise Program for the Blind (program). The program provides participants the opportunity to be self-supporting by establishing vending facilities throughout the State and training qualified blind people to operate their own vending businesses. It also provides a voluntary pension plan for program participants. Federal grant money, the State's General Fund, vendor fees and contributions, and vending machine commissions fund the program. The department accounts for the receipt and use of vendor fees in the Vending Stand Account—Special Deposit Fund (vending stand fund) and the receipt and use of vending machine commissions in the Vending Machine Trust Fund (vending machine fund).

Our review finds that the vending stand and vending machine funds are financially sound. However, two issues need attention. First, compared to its average annual costs, the surplus in the vending stand fund appears excessive. Specifically, as of June 30, 1997, the vending stand fund's assets exceeded its liabilities by \$4,357,000; the unreserved portion of this surplus was sufficient to pay more than two years' worth of its average annual costs.

Additionally, although income from commissions has increased since our last audit because of the department's stepped-up collection efforts, the department can increase this income more than 35 percent if it establishes contracts for all vending machines on state and federal property. As of June 30, 1997, the department had contracts for only 1,161 of the 3,287 vending machines from which it should be receiving commissions.

## RECOMMENDATIONS

To improve its financial management of the program, the department should do the following:

- Analyze the vending stand fund to determine whether its surplus is appropriate for future program needs. If warranted, the department should consider adjusting its vendor fee schedule.
- Continue its efforts to enter into contracts with vending machine companies, including dedicating additional staff to assist in establishing contracts.

## AGENCY COMMENTS

Although the department believes its vending stand fund surplus is not excessive, it plans to implement our recommendation to determine whether its surplus is appropriate. Additionally, the department believes that we overstated our estimate of the potential increase in vending machine commissions. Nonetheless, the department states that, although it is unable to dedicate additional staff to contracting at this time, it will continue to review the issue. Our comments follow the department's response. ■

# INTRODUCTION

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## BACKGROUND

**T**he Department of Rehabilitation (department) administers the Business Enterprise Program for the Blind (program) in accordance with the federal Randolph-Sheppard Act and the California Welfare and Institutions Code. The program's purpose is to provide blind people gainful employment, enlarge their economic opportunities, and stimulate the blind in becoming self-supporting. To accomplish this, the program provides training and vending facilities to enable qualified blind people to operate their own vending businesses throughout the State. As of January 1997, the department provided rehabilitative services to approximately 5,000 blind individuals, 180 of whom participate in the program.

### Participation in the Program

Interested department clients are referred by its counselors to the program. The department provides accepted clients with a comprehensive six-month food service training course and licenses those who successfully complete the course as vendors. The vendors then apply to operate a department-established vending facility, such as a cafeteria, snack bar, vending stand, or vending machine. After the department awards a vendor a location, the program pays for equipment and certain start-up costs. The program continues to serve the vendors while they remain active in the program, procuring and repairing equipment, as well as providing consulting services. The program also offers vendors a voluntary retirement plan.

### Funding for the Program

The program is funded by federal funds, the State's General Fund, vendor fees and contributions, and vending machine commissions. Federal funds provide for the purchase of new and replacement equipment, initial stock and supplies for a facility, and management services of the department. For allowable costs, the federal share is approximately 80 percent. Depending on the nature of the expense, the State's General Fund or vendor fees cover the remaining 20 percent. Vendor fees are money the program requires vendors to set aside from the net income of their operations. The program uses these fees, which the

department accounts for in the Vending Stand Account— Special Deposit Fund (vending stand fund), for maintenance and replacement of equipment, purchase of new equipment, construction of new vending facilities, and other miscellaneous costs. The program also receives commissions from vending machines located on state and federal property within California. It disburses this income, which the department accounts for in the Vending Machine Trust Fund (vending machine fund), either to vendors or to the vendor pension plan. Finally, vendors participating in the pension plan are required to make monthly contributions to the plan and may voluntarily contribute additional amounts, which the department also deposits in the vending machine fund.

### Results of Previous Audit Reports

The Bureau of State Audits (bureau) previously issued a financial audit report in August 1995 and a program audit report in August 1997 for the program. The financial audit report concluded that the program was sound financially but noted some weaknesses in the department's internal control structure and in its compliance with certain laws and regulations. The program audit report concluded that poor management practices limit the program's effectiveness and found continuing internal control weaknesses. In both audits, we recommended that the department do the following:

- Improve its management of missing profit and loss reports.
- Further improve its efforts to maximize vending machine commissions.
- Improve its controls over program assets.

The department has improved its management of profit and loss reports and its controls over program assets. However, as we discuss in the Audit Results section of this report, it needs to continue its efforts to maximize vending machine commissions.

### SCOPE AND METHODOLOGY

The California Welfare and Institutions Code, Section 19640.5, requires the bureau to conduct a fiscal audit of the program every third fiscal year and a programmatic review and audit



every five years. This, our third audit, covers the fiscal year ending June 30, 1997. Our first fiscal audit covered the fiscal year ending June 30, 1994.

We reviewed selected account balances of the vending stand and the vending machine funds. Appendix A and Appendix B summarize the funds' accounts and their respective balances as of June 30, 1997; the accounts we selected to review appear in bold type. Further, we reviewed the program's payroll and distributed administrative costs charged to the State's General Fund. Finally, we reviewed the department's efforts to correct the weaknesses reported in our first fiscal audit of the program, which were still apparent during our programmatic review.

For both the vending stand and the vending machine funds, we reviewed the cash, fund balance, revenue, and expenditure accounts. We selected the cash and fund balance accounts because they provide useful information relative to the financial condition of the program. Fund balance is the difference between total assets and liabilities—in other words, the difference between the amount owned and the amount owed. It represents the resources available to the program in the future. We selected revenue and expenditure accounts because they show how much the program received in fees and commissions and how much of this money it spent.

For each of these accounts, we determined the accuracy, appropriateness, and completeness of the reported amounts. For the cash accounts, we reviewed the department's June 30, 1997, cash reconciliation. For the revenue accounts, we reviewed the supporting accounting records for a sample of fees and commissions and verified that the amounts recorded had been received, correctly recorded, and appropriately classified. In addition, we analyzed the department's records for fees and commissions due but not received. For a sample of expenditures, we reviewed the supporting accounting records and verified that the payments were duly authorized, correctly recorded, and an appropriate use of program money. In addition, for each of the accounts, we reviewed the department's reconciliations of its accounting records, including the reconciliation of its June 30, 1997, account balances with balances maintained by the State Controller's Office. Further, we analyzed the year-to-year changes in the account balances from fiscal years 1993-94 through 1996-97.

Finally, to determine the reasonableness of the costs it charged to the State's General Fund, we reviewed the program's payroll and distributed administrative costs. We verified that payroll was properly recorded in the accounting records and that the payroll cost was for individuals working in the program. In addition, we analyzed the reasonableness of the department's methodology for distributing administrative costs to the program. ■

# AUDIT RESULTS

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## ***Some Opportunities Exist to Further Improve the Financial Management of the Business Enterprise Program for the Blind***

### SUMMARY

**T**he Vending Stand Account—Special Deposit Fund (vending stand fund) and the Vending Machine Trust Fund (vending machine fund) are financially sound, and although the Department of Rehabilitation (department) has improved its financial management of the Business Enterprise Program for the Blind (program), some opportunities for further improvement exist. As of June 30, 1997, assets exceeded liabilities in the vending stand fund by \$4,357,000 and in the vending machine fund by \$118,000. However, the surplus of assets in the vending stand fund appears excessive compared to its average annual costs. Additionally, although income from vending machines and contributions to the vendor pension plan have grown significantly since our last audit, the department could increase vending machine income more than 35 percent by establishing contracts for all vending machines located on state and federal property.

### BOTH FUNDS ARE FINANCIALLY SOUND

Both the vending stand and the vending machine funds have positive fund balances. A positive fund balance—sometimes called a surplus—means that the funds' assets, which are primarily cash, exceed their liabilities, the amounts they owe. Although a positive fund balance indicates that the program is financially sound, which is important, it does not measure the program's efficiency or effectiveness. In fact, an overly large surplus could indicate that the department is not spending enough on the program or that program fees are too high. We did not review the program's efficiency or effectiveness during this audit.

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*An overly large surplus could indicate that the department is not spending enough on the program or that program fees are too high.*

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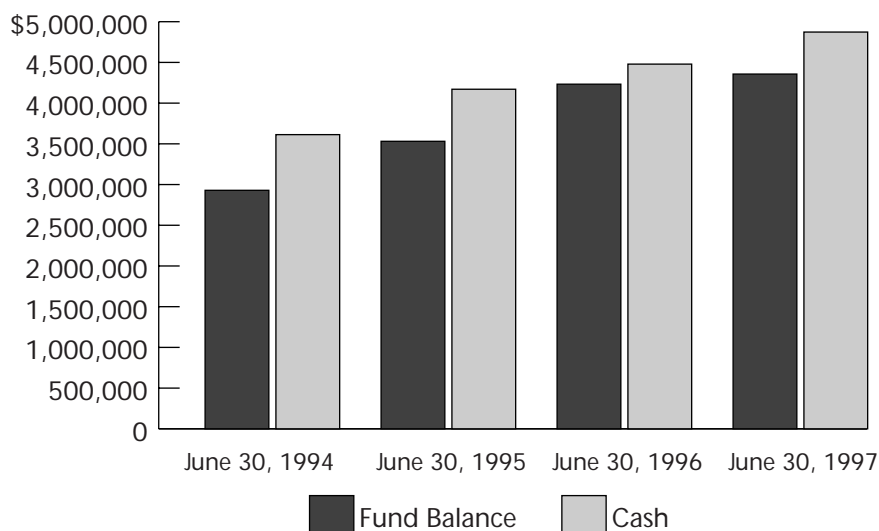
### *The Vending Stand Fund Balance Increased Substantially*

Vendor fees are the primary source of income for the vending stand fund, which uses these fees to pay the fund's share of certain program costs. These costs include the purchase of new vending equipment, the construction of vending facilities, and the maintenance of vending equipment.

Because the department consistently spent less on program costs than it received in revenue, the vending stand fund's surplus has grown. Between June 30, 1994, and June 30, 1997, its fund balance grew from \$2,929,000 to \$4,357,000. During the same period, its cash balance increased by more than \$1,260,000, from \$3,613,000 to \$4,873,000. Figure 1 shows the growth in the cash and fund balance.

**FIGURE 1**

**The Vending Stand Fund's Cash and Fund Balance Accounts Have Grown**



The fund balance is the amount available for future program needs. However, a portion may be set aside for a specific purpose. For example, because vendors participate in a self-insured workers' compensation program, the department reserved \$875,000 of the fund balance to pay future claims for work-related injuries of vendor employees. In all, the department had

*The vending stand fund's surplus appears excessive compared to its average annual costs.*

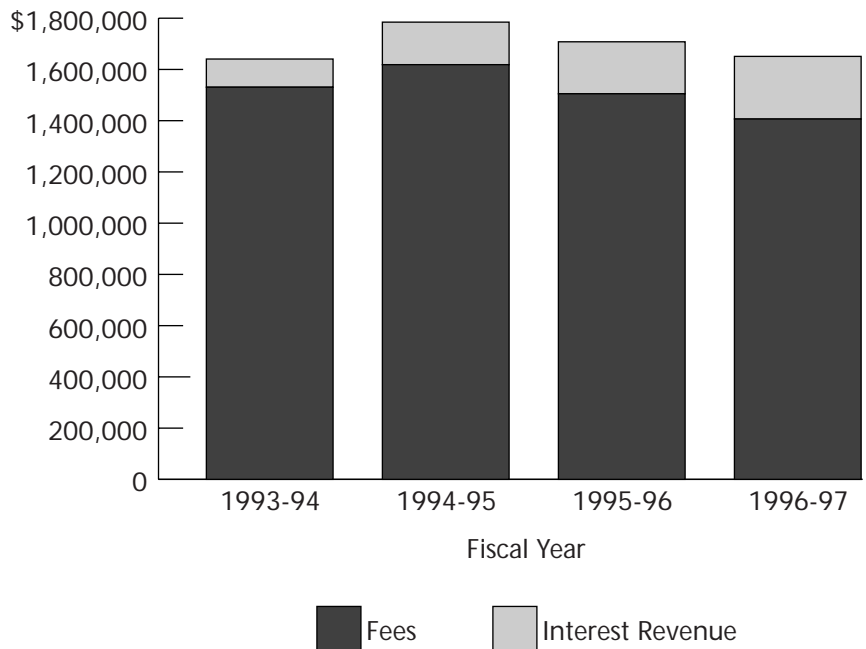
set aside or reserved \$1,122,000 as of June 30, 1997, leaving \$3,235,000 of the \$4,357,000 fund balance for other future program needs. Because the fund's annual program expenditures have averaged about \$1,164,000 after adjusting for vendor reimbursements, this \$3,235,000 unreserved fund balance, which is sufficient to pay for 2.8 years' worth of expenses, appears excessive.

The department plans to construct, remodel, and equip several vending facilities in the next few years, which it estimates will decrease the unreserved surplus in the vending stand fund to \$1,992,000 by June 30, 2000. However, even at this reduced level, the unreserved surplus represents more than one year's average expenditures and may be excessive.

The vending stand fund's surplus continued to grow despite a slight decrease in revenue in recent years. A closer look at the fund's revenue disclosed that the fees it receives from vendors have decreased; however, increases in interest revenue have partially offset this decrease. Figure 2 shows the composition of the fund's revenue.

**FIGURE 2**

**Vending Stand Fund Revenue Is Decreasing**



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*Although overall revenues have decreased, the average net proceeds per vendor actually grew.*

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Since fiscal year 1994-95, when they reached a high of \$1,619,000, the vendor fees have decreased by approximately \$100,000 each year. The vendor fees are based on the net proceeds of vendor operations. Statistics the department reported to the federal government show that for the federal fiscal year ending September 30, 1995, 255 vendors participated in the program. However, for the year ending September 30, 1997, only 214 vendors were participating in the program, a 16.1 percent decrease. These statistics also show that the annual net proceeds decreased from \$7,359,000 to \$6,631,000 during this same period. However, the average net proceeds per vendor actually increased from \$28,859 to \$30,986, indicating that the decrease in vendor fees is attributable to the decline in the number of vendors. The department said the number of vendors decreased because it has fewer vending locations. Because the majority of locations are situated in federal, state, and county buildings, changes in the way government does business, such as downsizing and allowing employees to work from home, have negatively affected the number of locations.

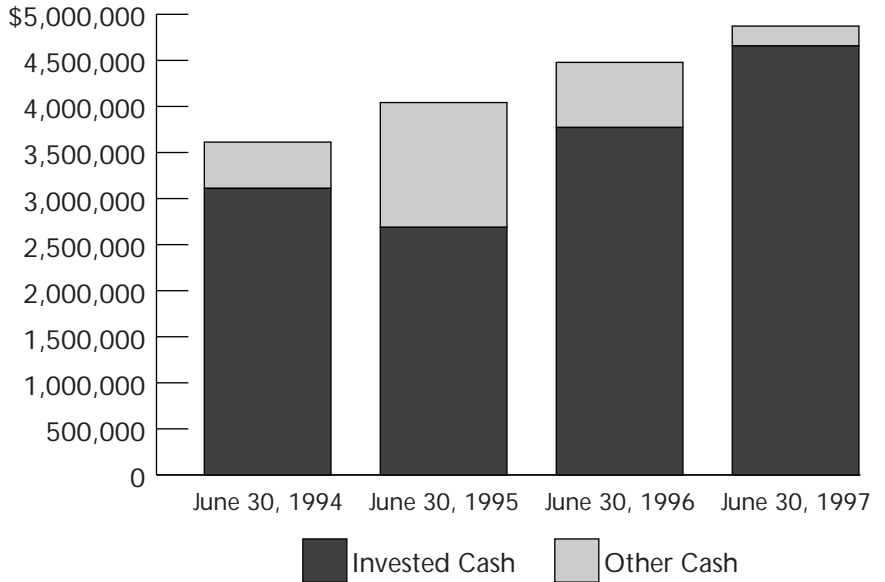
The decrease in annual revenue from vendor fees was mitigated by the interest the vending stand fund earned on its invested cash balances. The department invests cash that is not needed for daily operations in the State's pooled money investment program. Under this program, the state treasurer invests participants' cash and distributes the interest earned on the investments back to the participants. As shown by Figure 3 on the following page, not only has the cash balance grown in total, the invested portion has also increased. This growth in invested cash has increased interest revenue.

#### **The Vending Machine Fund Increased Its Revenue and Contributions to the Pension Plan**

The vending machine fund receives money from vendors for contributions to their pension plan and from commissions on vending machines located on state or federal property, but not operated by a blind vendor. The commissions, which vending machine operators remit to the department, can be classified into two categories: those owed to individual vendors, and those unassigned. Vendors operating facilities in buildings with vending machines receive the commissions from machines competing with the vendors' operations. The majority of the unassigned commissions go to the vendors' pension plan.

**FIGURE 3**

**The Vending Stand Fund Is Investing  
More of Its Growing Cash Balance**



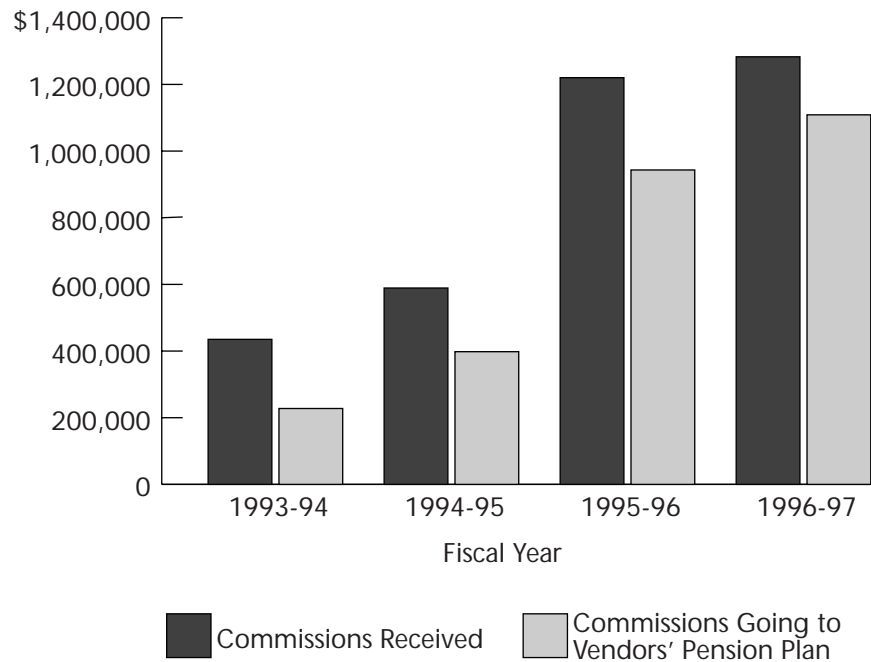
The financial condition of the vending machine fund is sound. Its surplus has fluctuated from a high of \$279,000 at June 30, 1994, to a low of \$74,000 at June 30, 1995. Similarly, its cash balance fluctuated from a high of \$437,000 to a low of \$260,000. Although these amounts are significantly lower than the same accounts in the vending stand fund, this is to be expected because of the nature of the vending machine fund. The vending machine fund functions as a “pass-through” fund: Almost all of the cash coming into the fund is paid to vendors and the pension plan within a few of months of receipt. The department retains only a small amount of cash for unforeseen expenses.

The vending machine fund’s income from commissions has increased significantly, and its contributions to the vendors’ pension plan mirror this growth. Figure 4 on the following page displays both the income from commissions and payments to the vendors’ pension plan for the last four years. Vending machine commissions have grown from \$435,000 in fiscal year 1993-94 to \$1,283,000 in fiscal year 1996-97. At the same time, annual contributions to the blind vendors’ pension plan from these commissions have grown from \$228,000 in fiscal year 1993-94 to \$1,109,000 in fiscal year 1996-97. The department

said these increases are the result of a 1995 court decision that invalidated state regulations exempting certain agencies from remitting to the program all income from vending machines located on state property.

**FIGURE 4**

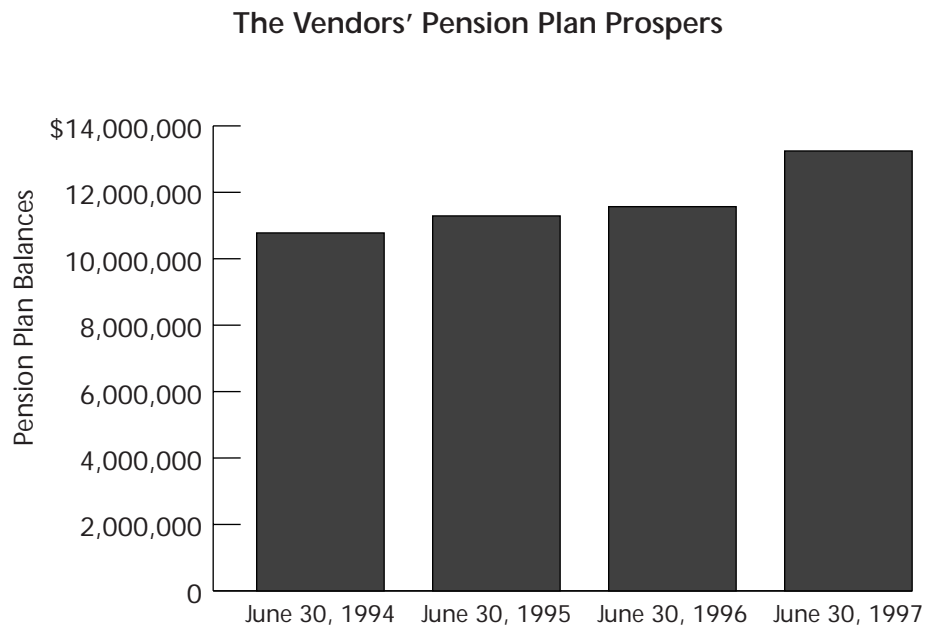
**As Commissions Have Increased, Contributions to the Vendors' Pension Plan Have Also Grown**



Because the department is collecting more commissions than ever before, the vendors' pension plan is prospering. As mentioned previously, the department contributes most of the unassigned commissions to the vendors' pension plan, which is maintained by an outside custodian. As seen in Figure 5, at the end of fiscal year 1993-94, the pension plan balance was \$10,698,000. However, since then, the pension plan balance has grown by \$2,911,000 to \$13,609,000 at June 30, 1997.



**FIGURE 5**



However, as we discuss in the next section, opportunities to collect more commissions continue to exist.

#### **OPPORTUNITIES FOR ADDITIONAL COMMISSIONS STILL EXIST**

Although it has made progress in collecting vending machine commissions, as we reported in previous audits, the department is still not ensuring that it receives all vending machine commissions available to the program. State law requires the department to actively pursue all commissions from vending facilities on state and federal property that are not operated by blind vendors. Further, an August 1995 interim order issued by the Sacramento County Superior Court requires the department to actively pursue and collect all income from vending machines on state property and from state agencies previously exempt from paying vending machine commissions. To fulfill these requirements, the department identifies vending machines located on state and federal property not operated by blind vendors and establishes contracts with the vending machine companies to secure commissions.

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*If all the vending machines identified were under contract, the department could potentially increase annual commissions by \$489,000, or 38 percent.*

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Although the department has made progress in identifying vending machines and increasing the number of contracts, most machines are still without a contract. Our first fiscal audit found that the department had identified approximately 880 vending machines and had 186 of the machines under contract, or 21 percent. In contrast, as of June 30, 1997, the department had identified approximately 3,287 vending machines and had 1,161 of the machines under contract, or 35 percent. Even though the department has increased the number of machines under contract by 975, or 524 percent, it has yet to obtain contracts on 2,126 machines of those it identified, or 65 percent.

If the department had contracts for the remaining 2,126 machines, it could substantially increase annual commissions. Although it receives commissions from vending machines with and without contracts, the department can neither determine nor control the amount of commissions it should receive from machines without contracts. During fiscal year 1996-97, the department received \$1,283,000 in commissions. Of this amount, approximately \$547,000 was from 1,015 of the vending machines under contract for an average of \$539 per machine.<sup>1</sup> If all 3,287 vending machines identified as of June 30, 1997, were under contract, the department could potentially receive annual commissions of \$1,772,000, an increase of \$489,000 per year, or 38 percent.

According to the department, it temporarily redirected several staff to execute more contracts. However, it cannot continue to redirect staff to contract with vending machine companies because it has limited resources and is committing those resources to its highest-priority needs. Nonetheless, it will continue to request additional vending machine contracting staff. By not dedicating additional staff, the department misses an opportunity to substantially increase commissions and annual contributions to the vendors' pension plan.

Since our last programmatic audit, the department has taken steps to identify and establish contracts for vending machines at previously exempt state agencies. The department has contacted these agencies and, except for the California State University,

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<sup>1</sup>The department did not receive commissions from 146 of the 1,161 vending machines under contract because either the contracts were too recent or the machines had not been installed. Thus, we excluded them from our computation.

has either established contracts or is working with the agencies and vending machine companies to establish contracts. The California State University continues to assert that it has statutory authority to keep the revenue generated by its vending machines. Thus, without legal action, this issue cannot be resolved. According to the department, it sought, but was not granted, permission to pursue legal action.

## RECOMMENDATIONS

To improve its financial management of the program, the department should determine how much money it needs in the vending stand fund to remain financially sound and meet future program needs. If warranted, the department should consider adjusting its fee schedule.

Also, the department should continue its efforts to establish more contracts with vending machine companies, including dedicating additional staff to this task.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG  
State Auditor

Date: January 26, 1999

Staff: Sylvia L. Hensley, CPA, Audit Principal  
Robert Cabral, CPA, CIA  
Jonathan Kim

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# APPENDIX A

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## ***Vending Stand Account— Special Deposit Fund Fiscal Year 1996-97 Account Balances<sup>1</sup>***

Assets, Liabilities, and Fund Balance as of June 30, 1997	
Assets	
<b>Cash</b>	<b>\$4,873,000</b>
Other assets	280,000
<b>Total Assets</b>	<b>\$5,153,000</b>
Liabilities <sup>2</sup>	\$ 796,000
<b>Fund balance</b>	<b>4,357,000</b>
<b>Total Liabilities and Fund Balance</b>	<b>\$5,153,000</b>

Revenues, Expenditures, and Net Income for the Fiscal Year Ended June 30, 1997	
Revenues	
<b>Vendor fees</b>	<b>\$1,407,000</b>
Vendor penalties	16,000
<b>Interest revenue</b>	<b>244,000</b>
<b>Total Revenues</b>	<b>1,667,000</b>
<b>Expenditures<sup>3</sup></b>	<b>(1,543,000)</b>
<b>Net Income</b>	<b>\$ 124,000</b>

<sup>1</sup> We selected and reviewed the accounts in bold.

<sup>2</sup> We reduced the liabilities by \$746,000 to correct errors in estimates of costs incurred, but not paid, at year-end.

<sup>3</sup> We reduced expenditures by \$726,000 for vendors' reimbursements of insurance costs and by \$746,000 to correct errors in estimates of costs incurred, but not paid, at year-end.

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# APPENDIX B

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## ***Vending Machine Trust Fund Fiscal Year 1996-97 Account Balances<sup>1</sup>***

Assets, Liabilities, and Fund Balance as of June 30, 1997	
Assets	
<b>Cash</b>	\$ 276,000
Total Assets	\$ 276,000
Liabilities	\$ 158,000
<b>Fund balance</b>	118,000
Total Liabilities and Fund Balance	\$ 276,000

Revenues, Expenditures, and Operating Loss for the Fiscal Year Ended June 30, 1997	
Revenues	
<b>Vending machine commissions</b>	\$ 1,283,000
Vendor pension contributions	247,000
Total Revenues	1,530,000
<b>Expenditures</b>	(1,542,000)
Operating Loss	\$ (12,000)

<sup>1</sup> We selected and reviewed the accounts in bold.

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*Agency's response to the report provided as text only:*

DEPARTMENT OF  
**REHABILITATION**

*Employment and Independence for Californians with Disabilities*

State of California - Health and Human Services Agency

GRAY DAVIS, *Governor*

Director's Office  
2000 Evergreen Street  
Sacramento, CA 95815-3832  
TEL: (916) 263-8987  
FAX: (916) 263-7474

January 13, 1999

Kurt Sjoberg  
State Auditor  
Bureau of State Audits  
555 Capitol Mall, Suite 300  
Sacramento, CA 95814

Dear Mr. Sjoberg:

Enclosed is the response to the report entitled "Department of Rehabilitation: The Business Enterprise Program for the Blind Is Financially Sound, but Opportunities for Improvement Exist". Also, enclosed is a diskette with a copy of our response.

If you have any questions regarding the response, please contact Jean Johnson, Audit Chief, at (916) 263-8935.

Sincerely,

*Signed by: R. R. Bayquen*

R. R. Bayquen  
Chief Deputy Director

Enclosures

cc: Grantland Johnson, Secretary  
California Health and Human Services Agency

## **Business Enterprise Program**

### **Response to the Financial Audit conducted by the Bureau of State Audits**

The Bureau of State Audits' (BOSA) financial audit of the Business Enterprise Program (BEP) disclosed that the vending stand and vending machine funds are financially sound. The BOSA did, however, note that two issues require attention. Those two issues were presented as recommendations to improve the financial management of the program.

- Analyze the vending stand fund to determine whether its surplus is appropriate for future program needs. If warranted, the department should consider adjusting its vendor fee schedule.
- Continue its efforts to enter into contracts with vending machine companies, including dedicating additional staff to assist in establishing contracts.

#### **Response to Recommendation #1 - Analyze Vending Stand Fund**

The BOSA notes that the vending stand fund has grown over the past three years because the department has consistently spent less on program costs than it received in revenue. As a result, the vending stand fund's assets exceeded its liabilities by \$4,357,000 as of June 30, 1997. In the body of the report BOSA points out that \$1,122,000 is reserved to pay future claims for work-related injuries of vendor employees and other specific purposes, which leaves a balance of \$3,235,000 for future program needs.

According to BOSA, that amount is sufficient to pay for 2.8 years' worth of future expenses, which it feels is excessive.

The Department of Rehabilitation (DR) provided the BOSA a projection of program costs for the current year and budget year which will decrease the surplus in the vending stand fund to \$1,992,000 by June 30, 2000. The DR projected program expenditures will substantially increase in fiscal years 1998-99 and 1999-00 due to the planned construction of road side rest stop build-outs, Department of Correction prison build-outs, and existing facility remodeling. The BOSA points out that even at this reduced level the surplus represents more than one year's average expenditures and may be excessive.

The DR believes that a surplus in the vending stand fund of \$1,992,000, as of June 30, 2000, is an appropriate and prudent reserve. This belief is based on the average yearly program expenditures from 1997-2000. The table below illustrates the expenditure levels for the past two fiscal years, along with a projection of expenditures for current year, and budget year.

	<u>1996/97</u>	<u>1997/98</u>	<u>1998/99</u>	<u>1999/00</u>
Expenditures	1,542,000	1,620,000	2,699,321	2,612,630

The average annual program expenditure level for these four fiscal years is projected to be \$2,118,487. Using that as a basis for future program growth, and absent a recommendation from the BOSA regarding its suggestion for an appropriate reserve, the DR believes \$1,992,000 is not an excessive surplus. The BOSA used the average program expenditure for the past four fiscal years (\$1,164,000) as its gauge to determine that a surplus of \$1,992,000 is excessive. The DR feels that it is more realistic to base an appropriate reserve on more recent expenditure levels and a projection for the current and budget fiscal years, such as the DR has illustrated above, rather than rely on historical costs which may not accurately reflect future program growth. The DR will analyze the vending stand fund at the end of fiscal year 1998-99 and subsequent fiscal years to determine whether the level of surplus is appropriate for future program needs. If warranted, the DR will consider adjusting its vendor fee schedule at that time.

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\*California State Auditor's comments on this response begin on page R-7.

## **Response to Recommendation #2 - Continue Efforts to Contract with Vending Machine Companies**

The BOSA acknowledges that the DR has made progress in collecting vending machine commissions by pointing out that vending machines under contract have increased by 524 percent since its last audit. At that time, of the 880 identified vending machines, 186 were under contract. As of June 30, 1997, the DR had identified approximately 3,287 vending machines and had 1,161 under contract. Even so, the BOSA notes that the DR has not obtained contracts on 2,126 vending machines. According to BOSA the DR could substantially increase annual commissions if all 3,287 vending machines were under contract.

While the DR agrees that having all vending machines under contract would be desirable, it does not agree with BOSA's fiscal projections. The BOSA notes that during fiscal year 1996-97, the DR received \$1,283,000 in commissions. Of that amount, approximately \$547,000 was from 1,015 of the vending machines under contract for an average of \$539 per machine. Using that as a basis, the BOSA concluded that if all 3,287 vending machines were under contract, the DR could potentially receive annual commissions of \$1,772,000 ( $3,287 \times 539$ ), an increase of \$489,000 per year, or 38 percent.

② The DR disagrees. Although the BOSA's mathematical computation is correct, it has made an incorrect assumption. The BOSA incorrectly assumes that all vending machines currently not under contract will generate an annual average of \$539 per machine once a contract is in place. The vending machines upon which BOSA based its assumptions were machines brought under contract soon after the 1995 court interim order struck down a regulation which had exempted some state agencies from paying vending machine commissions to the DR.

At that time, the DR focused its contracting efforts on those machines that would produce the highest level of vending income.

For example, approximately 240 of the 1,015 vending machines used by BOSA to arrive at its annual average income were Department of Corrections' visiting room vending machines, with an average annual income of \$1,102. Once the DR had secured contracts on the high volume vending machine locations, it began the process of identifying and contracting for all remaining vending machines, many of which are located in small offices and remote locations which will generate significantly less annual income. As a result, the BOSA gleaned its figures from a majority of the high volume vending machines that the DR contracted for in 1996 and 1997 and, using those figures, determined that the remaining vending machines would produce similar income. Therefore, BOSA's conclusion that the DR could potentially receive an increase of 38% in annual commissions is overstated.

The DR will continue to review the issue of dedicating additional staff to the program with the goal of bringing all vending machines under contract. However, the BEP program already receives a relatively greater amount of resources per client than DR's vocational rehabilitation program clients. Since the vocational rehabilitation program, which serves 80,000 clients, is not an entitlement program, DR must operate with funding available. As a result of limited funding, there are more than 7,000 Californians with disabilities who are on the waiting list for services. Shifting already limited resources to add to BEP would further tax the vocational rehabilitation program and increase the waiting lists. In addition, the DR must continue to attain a 12.4 percent salary savings level. As a matter of priority, DR is unable to dedicate additional resources to this activity at this time.

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# COMMENTS

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## ***California State Auditor's Comments on the Response From the Department of Rehabilitation***

**T**o provide clarity and perspective, we are commenting on the Department of Rehabilitation's (department) response to our audit report. The numbers below correspond with the numbers we have placed in the response.

- ① The department's statement is incorrect. When we assessed the propriety of its projected surplus, we based our average on the past five years' actual expenditures plus the department's projected expenditures for fiscal years 1998-99 and 1999-00. We included its projected expenditures in our calculation to obtain a conservative estimate of the surplus. However, contrary to the department's viewpoint, we believe that historical information provides a more realistic basis for assessing the surplus because the department's projections lack adequate support and it has traditionally overestimated its expenditures. For example, the Governor's Budget shows the department has estimated expenditures of \$3.36 million each year since fiscal year 1994-95 for the vending stand fund, yet its actual expenses have never exceeded \$1.62 million. Thus, we stand by our conclusion that the surplus appears excessive and are pleased to see the department plans to implement our recommendation, even though it does not agree with our conclusion.
- ② We disagree with the department's assertion that we have overstated the potential increase in annual commissions by using a \$539 per machine average commission. Although the department is correct that the vending machines located in the Department of Corrections' visiting rooms generate more income than other machines under contract, it is wrong that we have overstated the potential income by basing our projection on the average commissions received from all machines under contract. In fact, as demonstrated in the following table, our \$539 estimate is conservative.

**Average Vending Machine Commissions  
Fiscal Year 1996-97**

	Number of Machines	Commissions Received	Average per Machine
Machines Under Contract:			
Department of Corrections	240	\$264,000	\$1,100
Other Locations	775	283,000	365
<b>Total Machines Under Contract<sup>1</sup></b>	<b>1,015</b>	<b>\$547,000</b>	<b>539</b>
Machines Not Under Contract	1,242	736,000	593
<b>Total</b>	<b>2,257</b>	<b>\$1,283,000</b>	<b>568</b>

<sup>1</sup> As noted on page 14, we excluded 146 of the 1,161 vending machines under contract from our computation because either the contracts were too recent or the machines had not been installed.

As we state on page 14, the department receives commissions from vending machines with and without contracts. During fiscal year 1996-97, the department received an average of \$568 from each of the 2,257 machines that were under contract or paid commissions. However, rather than basing our projection on this figure, we based it on the more conservative average of commissions received only from machines under contract.

Despite its questioning of the amount of additional income potentially generated from executing more contracts, we are pleased the department acknowledges the more important issue—the desirability of contracts. As we state on page 14, without contracts, the department can neither determine nor control the amount of commissions it receives.