Office of the Auditor General

REPORT OF THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

239.3

BUDGETARY AND CASH MANAGEMENT OPERATIONS OF THE DEPARTMENT OF TRANSPORTATION

DECEMBER 1976

Joint Legislative Audit Committee

OFFICE OF THE AUDITOR GENERAL

California Legislature

MIKE CULLEN
CHAIRMAN

December 6, 1976

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

Members of the Legislature:

Your Joint Legislative Audit Committee respectfully submits the Auditor General's report on the budgetary and cash management procedures employed by the Department of Transportation. The Auditor General finds that these procedures do not approach reasonable and prudent financial plans for effective reporting and control.

Confidence in transportation management by the Governor, the Legislature, and the general public cannot be achieved until the Department of Transportation adopts budgeting, cash management and reporting procedures acceptable to the Governor.

By copy of this letter, the Department is requested to advise the Joint Legislative Audit Committee within sixty days of the status of implementation of the recommendations of the Auditor General that are within the statutory authority of the Department.

The auditors are: Richard Porter, Michael McGarity, Dennis Sesler and Kenneth Mason.

Respectfully submitted,

Mike Cullen

MIKE CULLEN, Chairman
Joint Legislative Audit Committee

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SUMMARY

Significant discrepancies occur both (1) between the highway budget amounts submitted at different times for the same budget year and (2) between the highway budget and the actual experience. For example, the highway budget submitted January 10, 1976, when the 1975-76 fiscal year was half over, shows estimated expenditures to be almost 40 percent greater than the original budget, although substantial actions had already been taken which materially reduced expenditures. The actual expenditures for the year were 47 percent below the midyear budget.

The paradox that the budget reports show the highway program being significantly expanded when, in fact, it was being substantially reduced, occurred because neither the budget nor the related accounting records reflect transactions on a consistent basis necessary for the budget to represent the financial plan.

Both the accumulation of larger than necessary cash balances and the delay in recovery of $110 million in federal reimbursements for prior costs incurred, extends the period between the payment of taxes by highway users and the use of the funds to provide highway improvements and services. The federal government experienced similar problems until the enactment of the Impoundment Control Act of 1974 which restricts the authority of the administration to delay the use of available resources. Similar State legislation could appropriate excess highway funds to the cities and counties to reduce the amount of local property taxes used for street and road purposes.

INTRODUCTION

In response to a request of the Joint Legislative Audit Committee and under the authority of Section 10527 of the Government Code, we examined the budgetary and cash management operations of the Department of Transportation.

The Governor's Budget submitted January 10, 1976 acknowledges that 99 percent of all person-trips are on roads, streets and highways, but also highlights the pronounced shift in emphasis away from the construction of new highways. The following comparison of the Department's proposed expenditures for the current and last fiscal years by program category evidences the magnitude of this change.

Program	1975-76	1976-77	Increase (Decrease)	Percentage Change
	(Millions of Dollars)			
Transportation Planning	$ 16.9	$ 12.6	$(4.3)	(25%)
Mass Transportation	3.6	12.1	8.5	236%
Aeronautics	4.4	4.3	(0.1)	(2%)
Highways	$1,359.5	924.2	(435.3)	(32%)
General Support	13.9	14.5	0.6	4%
All Programs	$1,398.3	$ 967.7	$(430.6)	(31%)

The following comparison of the highway program elements, also from the January 10, 1976 Governor's Budget submittal, shows that the collective decline in the proposed expenditures for new highway facilities and local assistance to cities and counties for streets and roads is more than $545,000,000.

Program Elements	1975-76	1976-77	Increase (Decrease)	Percentage Change
	(Millions of Dollars)			
Operations and Maintenance	$ 183.0	$ 194.3	$ 11.3	6%
Rehabilitation and Operating Improvements	100.9	199.9	99.0	99%
Local Assistance	384.0	151.8	(232.2)	(60%)
Program Administration	41.4	41.7	0.3	1%
New Facilities	650.2	336.5	(313.7)	(48%)
Highway Program Total	$1,359.5	$ 924.2	$(435.3)	(32%)

The magnitude of this projected 32 percent decline in street and road support, which was accomplished without enacted change in state transportation policy, has justifiably prompted public concern and continuing news media coverage. Peripheral speculation therein includes (1) whether this report has been delayed for political reasons and (2) if the appointments to fill the next two vacancies occurring on the State Highway Commission will terminate its dispute with the administration. This disagreement concerns the veracity of the system which produced the above dollar and related amounts. This report addresses that issue and describes deficiencies of the Department's state highway budget, cash management system, and actions to recover federal aid. Concern is warranted, and we recommend corrective legislation.

AUDIT RESULTS

SIGNIFICANT DISCREPANCIES EXIST IN THE BUDGET REPORTS OF THE DEPARTMENT OF TRANSPORTATION.

The Streets and Highways Code requires the Department of Transportation to annually submit a budget report of expected revenues, expenditures and obligations. This report is prepared prior to each legislative session and is included in the Governor's budget. The report includes three years of data for comparison purposes: the future budget year, the current budget year, which is half over at the time of submission, and the prior budget year.

The highway budget report differs from the balance of the Governor's budget in that significant discrepancies occur both (1) between the reported budget amounts submitted at different times for the same budget year and (2) between the budget amounts and the actual experience. For example, the Governor's budget submitted January 10, 1975 reflected proposed highway expenditures of $976 million for the 1975-76 fiscal year. To the contrary the budget submitted a year later on January 10, 1976, as required, when the 1975-76 fiscal year was half over, showed estimated expenditures of $1.359 billion, which was an increase of almost 40 percent over the original budget. However, six months later the actual expenditures recorded for the 1975-76 fiscal year were only $723 million, or <u>$637 million less</u> than that reported in the midyear budget and <u>$253 million less</u> than the original budget.

Material variations, such as a 40 percent increase of the midyear over the original budget and the 47 percent decline of actual expenditures from the midyear budget, would normally evidence that significant unforeseen events had occurred thereby causing erratic changes in the financial plan. The events which did in fact occur were contrary to those portrayed in the budget reports. During the first half of the 1975-76 fiscal year, the moratorium on the award of highway construction contracts was in effect and actions were being taken to reduce the Department's work force. Although both actions were taken to reduce expenditures, it is paradoxical that the budget report submitted January 10, 1976 showed both anticipated construction costs and total expenditures to be nearly 40 percent over the original budget. Appendix A shows the principal revenue and expenditure items reflected in those budgets and the actual experience for the 1975-76 fiscal year.

Function of the Highway Budget

The paradox of the budget reports showing the highway program as being significantly expanded when, in fact, it was being substantially reduced, occurred because neither the highway portion of the Governor's budget report nor the related accounting records reflected transactions on a consistent basis necessary for the budget to represent the financial plan. Rather than serving as the basis for financial planning and control, the highways budget and related accounting records fulfill two purposes which are unrelated to fiscal planning and are the cause of the problem. Because of this, practices have evolved which preclude the reported information from representing the fiscal plan and instead facilitate the following objectives:

- Expenditure Authorization - The budget system serves as the basis for authorizing work and the incurring of obligations. Prior approval to incur costs in excess of authorizations is required. However, by estimating costs on the "high side", the incident of the need to obtain approvals for cost overruns is reduced and so-called "savings" result. Fiscal flexibility is also thereby provided, but the resulting budget includes a substantial "cushion" for management error.

- Geographic Fund Distribution - The residual balance of state funds, after providing for planning, maintenance and general expenses, together with federal funds to be expended on the state system are subject to legislative formulas governing geographic distribution. Therefore, the Department's budgetary records are used to regulate and demonstrate compliance with these code restrictions.

Unique and highly technical yet conflicting accounting procedures have evolved. For example, a portion of capital outlay expenditures are provided and accounted for on the antiquated cash basis of accounting, while two different methods of modern accrual accounting are also used for other capital outlay costs with no indication provided that three different methods are used to account for these costs. The result is confusion: some costs provided in the current year budget are incurred before the fiscal year begins, while other costs are not incurred until years later, yet all are reflected in the budget as costs of the same budget year. The following table relates the Department's cash disbursements made during the 1975-76 fiscal year to the fiscal year budget records to which these costs were either "back-charged" or "forward-charged". Note that only 67 percent of the 1975-76 budget expenditures were charged to that year:

1975-76 Cash Disbursements

Charged to Budget Year		Amount	Percent
Current year - 1975-76		$497,725,927.42	67%
Subsequent year - 1976-77		9,293,977.93	1%
Prior years - 1974-75	$142,890,684.19		
1973-74	66,184,221.40		
1972-73	18,710,240.84		
1971-72	1,392,715.10		
1970-71	(90,274.83)		
1969-70	29,231.22		
1968-69	17,753.42		
1967-68	(325,203.30)		
1966-67	359,988.31		
1965-66	4,421,167.69		
1964-65	38,435.13		
1963-64	592,013.52	234,220,972.69	32%
Total Disbursements		$741,240,878.04	100%

One-third of the 1975-76 cash disbursements were accounted as expenditures of the subsequent year and 12 prior years. Only now is it possible to compare the budget for the 1963-64 fiscal year with the events accounted for that year with a high degree of confidence that all costs have been recorded, although after more than a decade, such comparison is of doubtful value. However, this comparison was not practical prior to the 1975-76 fiscal year, when cash disbursements of $592,013.52 were made against a provision of $168,357.04 for 1963-64 liabilities, which resulted in an increase of 1963-64 costs of $423,656.48.

These unique budgetary and accounting practices enable the Department to assure compliance with the code restrictions on fund use, but they require that other means be used to regulate current operations.

In April 1968, the Auditor General's Office issued an opinion on the Department's financial statements for the fiscal year ended June 30, 1966, which stated in part:

> Because of the condition of the records, the departures from generally accepted accounting principles, the absence or breakdown of controls in the accounting system, the omissions and duplications of amounts in the account balances, the inconsistent treatment of accounting transactions, and the inclusion of budgetary transactions in the representation set forth in the financial statements...the financial statements do not present fairly the financial position of the State Highway Fund (Account).

The situation today remains largely unchanged.

The Department's Inaccurate
Cash Management System

Major highway construction projects may take months and in some instances years to complete. The practice of retaining cash reserves sufficient to complete all projects being constructed seems prudent and conservative, yet it is unnecessary because revenues and federal reimbursements are continually realized as contract payments become due. However, to fully utilize federal resources as they become available and to prevent insolvency, the Department would need to carefully estimate future revenues by period of receipt and time expenditures to correspond with the projected revenue receipts.

However, the inaccuracy of the Department's present method of forecasting is revealed by comparing their history of projected cash balances developed by the cash management system, with the subsequent actual cash balances. In theory, some months' actual balances will be above the projected amounts, while other months' actual will be below the projected balance. In practice this has not occurred. Rather, the subsequent actual cash amount has been in each case consistently in excess of the projected balance by a substantial amount.

The critical cash balance is the low point during the month, because the objective is to fully utilize resources without becoming insolvent. The following table compares the June 1975 projected monthly low cash balances with the actual monthly lows, and reveals that the excess of actual monthly low cash balance over the forecasted lows increased from $22.8 million in October 1975 to $174 million in September 1976.

Twelve Month Comparison of Projected
Monthly Low Cash Balances With Actual Amounts

Month	Monthly Low Cash Balances Actual	Projected	Excess Over Projected
	(Millions of Dollars)		
October 1975	$29.6	$6.8	$22.8
November	34.5	8.3	26.2
December	33.2	3.7	29.5
January 1976	43.6	6.7	36.9
February	85.6	9.5	76.1
March	124.7	9.9	114.8
April	156.6	43.6	113.0
May	178.0	34.0	144.0
June	184.7	24.7	160.0
July	180.0	24.2	155.8
August	186.9	35.5	151.4
September	209.1	34.9	174.2

The tremendous increase in the disparity between the projected cash balances and the subsequent actual amounts is, in part, the consequence of the actions taken to curtail operations. It is also due, in part, to management's built-in "cushion". However, offsetting these considerations is the fact that the above comparison does not reflect an additional $110 million in cash which could have been realized if all federal funds due to the Department had been recovered in a timely manner. (This will be described in a subsequent section of this report).

The Department's cash forecasts in the light of hindsight have proved to be sufficiently inaccurate to justify the question as to whether the Administration's actions to curtail operations were necessary from a pure fiscal standpoint.

Need for Accurate and Effective Fiscal Planning

The Legislature appropriates funds for the support of the Department of Motor Vehicles, California Highway Patrol, Air Resources Board and other agencies eligible for highway user tax funding, but it does not regulate the residual balance available for the highway program. In lieu thereof, the Streets and Highways Code establishes limits on expenditure by geographic area and purpose (i.e., maintenance and administration). However, the Department has employed budgetary and accounting practices which properly facilitate compliance with the code restrictions, but which preclude the highway budget from serving a more important purpose - fiscal planning and control. The following conflicts currently exist:

Requirements for Effective Fiscal Planning	Present Department of Transportation Practice
- Uniformity in the budgetary provision and in the method of accounting for all items of revenue and expense.	- Inconsistent and misleading methods used in budget preparation and in accounting for both revenues and expenditures.
- Only the transactions planned to occur are provided for in the budget, and only the transactions which do occur are accounted during the fiscal year.	- Depending upon which method of accounting is used, transactions are reflected in different years' budgets without regard to when the transactions actually occur. Confusion results.
- Information to compare planned operations with actual experience is available soon after year end to facilitate planning for subsequent periods.	- Protracted periods occur, sometimes more than a decade before comparison can be made with confidence that all major transactions have been accounted for.
- All transactions provided for and accounted consistently without regard to the methods used to distribute costs.	- Provision for costs not consistently made with the different cost distribution methods regulating when costs are to be recognized.

For the major state transportation activities other than highways (i.e., Department of Motor Vehicles, California Highway Patrol, Air Resources Board and the Department of Transportation's nonhighway operations), there is little difference between the 1975-76 original and midyear budgets. The midyear budget for these organizations is $24 million, or 7.1 percent, above the original budget; this increase being close to that of the cost of living. In contrast, the highway budget submitted on January 10, 1976 was $383 million greater, or nearly 40 percent above the original budget, although actions had already been taken which later resulted in the 1975-76 actual expenditures being $723 million, or 47 percent below the midyear budget. These substantial discrepancies between (1) the original and midyear budgets and (2) the budgets and actual experience demonstrate the effects of the unique yet confusing highway budgetary and related accounting practices. (Any cause other than unique highway practices would have produced comparable discrepancies in the budgets of other transportation activities.)

Alternative Solutions to the Problem

The highway budget would properly reflect the fiscal plan, end the confusion, and serve as a necessary management tool if either of the following two alternatives were adopted.

- Amend the Streets and Highways Code to require that in addition to the presently required budget report, a budget prepared on the same basis as other state agencies' budgets shall be prepared and submitted to serve as the fiscal year financial plan.

- Specify that the budget be prepared in the same manner as other agency budgets and eliminate from the Streets and Highways Code the provisions which would be unnecessary if the highway budget were subject to conventional external review and approval. The elimination includes (1) geographic formula on construction expenditures, (2) restriction on maintenance and administrative costs, and (3) designation of the method of accounting for certain expenditures.

The first alternative would not require any change in institutional arrangements; that is, (1) the budget could still be the Highway Commission's prerogative and (2) the question of the Administration's authority to deviate from the specified amounts could be resolved as a separate issue. The second alternative connotes some change in institutional arrangements whereby the annual highway budget would no longer be exempt from external review and approval to which other state agencies are subjected.

In that both alternatives would enable the budget to reflect a realistic plan of operations, the selection of the alternative to be implemented is dependent upon whether change is also to be made in the institutional responsibilities for policy setting and enforcement which is now jointly shared by the Legislature, the Administration, the California Highway Commission and the State Transportation Board. The problem of the present institutional arrangement is described as follows in the University of California June 1976 report on the highway program.

> It seems fair to say that the turnabout in California's transportation program is the result of a breakdown in institutional arrangements. No time or place can be found where a deliberate and authoritative policy decision was made to wind down California's highway program, or to reduce allocation of resources to transportation generally. Contrary indications are that these things just happened, most likely by default.

Legislation which addresses the institutional arrangements is uncertain as to enactment. SB 1149, which would require all proposed expenditures except those for new facilities, operational improvements, or specified federal-aid projects, from the State Highway Account be appropriated by the Legislature, was vetoed.

The Governor's veto message identifies the SB 1149 problem as follows:

> This bill would fragment our process of transportation funding. The highway program should be reviewed for budget purposes as a total program. A split of responsibility for budgeting different elements of the program between the legislature and the California Highway Commission would preclude proper consideration of trade-offs between elements to ensure the most cost-effective use of tax resources.

This message evidences the uncertain future of legislation which would change the institutional arrangements governing highway policy that may be passed in the future sessions. Regardless of whether the current arrangements are changed, the highway budget should reflect the fiscal year financial plan with the degree of accuracy comparable to other state agencies, rather than portray change opposite to that which is occurring as was the case for the 1975-76 budget. Absent a conventional budgetary financial plan, confusion will continue.

SB 1149 would have made institutional changes, but left unchanged the Streets and Highways Code sections which continue to cause the unique and confusing highway budgetary and accounting practices. The Legislature would have made most of the highway appropriations but the information available to formulate such judgments would be no more accurate than that now available. The maintenance of two budgetary-accounting systems, one to enable compliance with the limitations on geographic and purpose of expenditures (as currently exists), and the other to reflect the fiscal year financial plan, is cumbersome. However, in view of the uncertain fate of proposals for institutional change and that more than a billion dollars needs proper management, this duplication is warranted.

According to internal memoranda within the Department, the deterioration in the cash management system's ability to accurately reflect future conditions in order to judiciously use available resources has resulted not only from neglect but from the philosophic difference between the current administration and its predecessors:

> Insufficient time exists to competently pursue, review and determine which courses of action should be taken in the making of such forecasts, particularly in the absence of clearcut policy guidelines. Even if we now had such needed policy guidance, it is my opinion that considerable time would still be required to secure and thoroughly analyze recent Fiscal Management records to update cash flow history (the upkeep of which has been neglected over the past few years) sufficiently to assure the production of competent and reliable long-range cash forecast in the near future.
>
> I believe this latter observation holds true irrespective of the complications which are being injected into the forecasting field due to the lack of clear policy guidelines by the present State Administration. As things now stand, it appears that the transportation philosophies of the present State administration differ so markedly from those we have experienced over the years through numerous past State administrations so as to make programming for the next few years an almost impossible task.

Inflation and the Department's Actions

The adverse effects of inflation are more serious on the highway program than most other state programs because:

- None of the sources of highway financial support have built-in inflation factors, whereas the principal support for most other major state programs is sales and income tax revenues which adjust automatically with inflation.

- Construction costs increase at a higher rate than consumer prices because energy costs are a large component. Not only are large amounts of fuel consumed by construction equipment, but also asphalt, which is a primary material for both construction and maintenance, is produced from the same raw material as is the primary energy supply oil.

The consequence of the Department's failure to use highway revenues in a timely manner is that the amount of interest earnings realized by banking federal highway funds and delaying expenditures does not offset for the loss in purchasing power occurring during the period that interest is being earned.

The same legislation specifying the submission of an annual fiscal year financial plan could also require information regarding the projected and actual cash utilization for the same three years reported in the annual budget. Thus, Section 143.7 could be added to the Streets and Highways Code to read as follows:

> In addition to the budget information required by other subsections of this section, the Department shall include in the fiscal year budget submitted to the Legislature, a separate fiscal year financial plan which is prepared on the same basis as is used in preparing the budgets of other state agencies. All items shall be included on the same basis and the budget current and prior year shall be reported. In addition to showing all items of revenue, reimbursement and expenditures, the beginning and ending anticipated and actual cash balances shall be shown together with amounts due from others, including the federal government, for expenditures made on their behalf.

CONCLUSION

Neither the Department budget nor its cash management system have provided accurate information evidencing the conditions and operations of the state highway program. Regardless of the institutional arrangements which establish and enforce controlling policies, accurate and useful information has not been provided.

RECOMMENDATION

The Legislature should add a requirement to the Streets and Highways Code which will produce budgetary information consistent with the balance of the Governor's budget, demonstrating the extent to which available resources will and have been used.

BENEFITS

Accurate projected and actual financial information regarding the state highway program will be provided, confusion will be alleviated, and more rational decisions involving uses of highway funds could be made.

DELAY IN RECOVERY OF FEDERAL REIMBURSEMENTS

The Department of Transportation was advised six months ago that approximately $110 million due from the federal government for its share of prior costs incurred under various federal highway programs, could be collected by merely amending existing reimbursement agreements and submitting claims to the Federal Department of Transportation. These actions have been started; however, only approximately 25 percent of the $110 million has been collected and the State has lost approximately $2 million in interest earnings and much more in purchasing power.

In June 1976, the Department identified the advantages and disadvantages of collecting these funds. The advantages identified were: (1) the State would earn the interest on these funds until they are utilized, and (2) administrative savings would be realized by claiming reimbursement for large projects both completed or near completion, rather than claiming reimbursement for a myriad of small projects in the future. The disadvantages identified were: (1) the receipt of these funds would add to the embarrassingly large existing cash balance and (2) future cash management "flexibility" would be reduced. This latter reason is complex, but it was recognized that it was not important because of changed conditions.

In part, the conditions which gave rise to the opportunity to collect this $110 million resulted from congressional action to restrict the federal Administration's authority to delay and withhold appropriated funds.

For several years prior to the enactment of the Impoundment Control Act of 1974, only portions of the federal highway appropriations were made available to the states. As a consequence, the cash balance of the federal Highway Trust Fund became excessive; a condition similar to that now existing in California. The 1976 Federal-Aid Highway Act contains provisions to temporarily assist the states in recovering these accumulated funds. Approximately $50 million of the $110 million due California relate to these provisions.

The remaining $60 million of the $110 million identified as recoverable is mostly the federal share of interstate right-of-way and preliminary engineering costs which had not been claimed by California for reimbursement. But federal limitations, such as the administrative withholding of congressional appropriations, prevented all eligible costs from being reimbursed to the states in a timely manner. Delayed recovery of these costs provided a ready reserve whereby cash could be obtained quickly in the event the cash management system failed to accurately project future conditions.

Construction projects normally are completed in a shorter time than are right-of-way and preliminary engineering projects. Therefore, to both improve cash flow and to provide the ready reserve, the following priorities are assigned. The State's authority to commit federal resources to projects is first assigned to construction projects with only the excess authority not necessary for construction committed to these other activities. The growth in the cash balance avoids the need for a ready reserve. This, together with the increase in the available federal resources to be committed by the state, eliminates the reason for delaying any federal reimbursement.

The failure to expeditiously realize available federal funds is, like the build-up of the cash balance, in accord with the Governor's notion of lowering expectations. However, both actions extend the time interval between the payments of state and federal taxes by highway users and the use of these funds to provide highway improvements and services. This is contrary to both sound fiscal management (e.g., inflation takes a heavier toll as the time interval increases) and the best interests of taxpayers. In addition, similar actions at the federal level were regarded by the courts in the decisions which preceded the federal Impoundment Control Act of 1974, as unconstitutional because the Administration was thereby performing a legislative function.

State legislation to accomplish the same purpose as the federal Impoundment Control Act of 1974, that is, to restrict the Administration's authority not to use taxpayer resources expeditiously, could either (1) establish a maximum on the amount of cash and federal receivables that can be accumulated (e.g., one or two months' normal cash needs) or (2) establish an alternate use for excessive accumulation.

The following reasons support the conclusion that funds not needed for immediate state highway needs should be reallocated to the cities and counties for street and road purposes.

- Local property owners not only pay the cost of local street and road construction either in the property purchase price or through property assessments, but also pay varying proportions of improvement and maintenance costs through local property taxes. Only the state finances all road costs from highway users revenues. Local governments make up the deficiency of the state subvened user's taxes to finance all street and road maintenance and improvement costs from other revenues primarily property taxes.

- Article 19 (formerly Article 26) of the State Constitution restricts the use of highway user tax revenues to street and road purposes and authorizes the Legislature to regulate the proportions to be allocated to city streets, county roads or state highways. Therefore, the accumulation of excess funds at the state level, which evidences that funds are not being expeditiously used, should be used at the local level if this will reduce the amount of other tax revenues being used for Article 19 purposes.

CONCLUSION

Like the accumulation of excessive cash, the failure to take the necessary actions to realize available federal reimbursements in a timely manner is not in the best interest of taxpayers and constitutes unsound fiscal management. This problem was resolved in the federal government by legislation restricting the administration's authority to withhold and delay the use of congressional appropriations.

RECOMMENDATIONS

Legislation to assure the expeditious recovery of federal aid and use of available resources should contain the following provisions: (1) the Department of Transportation should report monthly its cash balance and advances on behalf of the Federal Government to the Joint Legislative Budget Committee, (2) the available resources in excess of current needs, defined as the average expenditures for a two-month period, shall be determined by the Joint Legislative Budget Committee and shall be the maximum amount available for legislative appropriation and (3) the legislative appropriation shall be included in the annual budget bill and may include, but not be limited to, reallocations of funds to cities and counties to reduce the amounts of local taxes used to make up the deficits of subvened highway user taxes.

An opportunity also provided by the growth in the available highway resource is to create a countercyclical reserve which would be used to reduce the negative economic impacts of the normal business cycle. The construction industry experiences more radical "boom-bust" cyclical consequence than the entire economy. Therefore, by concentrating highway expenditures during periods of adverse economic conditions, the program would serve as a stabliizing force in the State's total economy.

BENEFITS

Assurance would be provided that resources available for street and road purposes are expeditiously used.

Respectfully submitted,

Wesley E. Voss for

JOHN H. WILLIAMS
Auditor General

December 3, 1976

Staff: Richard Porter
Michael McGarity
Dennis Sesler
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STATE OF CALIFORNIA—BUSINESS AND TRANSPORTATION AGENCY

EDMUND G. BROWN JR., Governor

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December 3, 1976

Mr. John H. Williams
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Sacramento, CA 95814

Dear Mr. Williams:

Thank you for your report on the budget and cash management operations of Caltrans. I appreciate the opportunity to respond to your findings and conclusions and look forward to our getting together in the near future to discuss our points of disagreement.

The following are some of our major comments on your report, explained in greater detail in the attachment:

-- We agree that the budget and fiscal operations of Caltrans are complex, hard to understand, and different from those of other departments. The format of our 1977-78 budget was changed last July and the new budget overcomes many of the deficiencies which existed in previous budgets.

-- To eliminate our practice of carrying over resources as you suggest would require the state to increase taxes in order to match federal aid, or to reduce future construction by a substantial amount.

-- If the department had not undertaken staff lay-offs, an advertising moratorium and other economy measures which you say were unnecessary, the state would have had to make up a $20-40 million deficit in the State Highway Account from the General Fund or some other source.

-- Our cash forecasts for the past year are said to have been inaccurate by up to 40%, whereas in fact they have been accurate within 10%.

-- The report suggests the department should have acted sooner in obtaining funds recently made available to California by a change in federal law. From a strict accounting standpoint you may be correct; however, in this case the result of a snap judgement if incorrect could have been the loss of some $250-300 million in future federal aid to California.

-- Since this Administration's policy is one of no new taxes, our approach has been to develop a reasonably constant level of capital outlay for the construction industry each year, a level workload for Caltrans employees, and a maximum return on investment by the timely matching of federal aid. These objectives seem to be in conflict with your approach to resource management.

Again, I appreciate the opportunity to comment on your report. My staff and I are available to discuss these points and others with you at your convenience.

Sincerely yours,

Adriana Gianturco

ADRIANA GIANTURCO
Director of Transportation

Attachment

COMMENTS BY CALTRANS ON

AUDITOR-GENERAL'S REPORT

A. Introduction

The report is organized in a confusing fashion, with much overlap and inconsistency between sections. In many places the analysis is obscure and specific points are hard to understand. Undue reliance is placed on faulty or incomplete data. Most unfortunately, the entire report appears to be written without thorough understanding of the nature of the highway program.

In the material that follows, we will first comment briefly on the characteristics of the highway program which do not appear to be understood in the report. We will then respond to specific statements and conclusions in the report, following the order of the report itself.

B. Nature of the highway program

The fundamental characteristic of the highway program managed by Caltrans is that it is, for the most part, a capital outlay or construction program. In this respect, the highway program differs basically from that of most state departments, including the other departments (Air Resources Board, California Highway Patrol, Department of Motor Vehicles) funded from the Motor Vehicle Account. As a program largely involving capital outlay, the highway program has certain basic features. First, the period during which projects are prepared for advertising and the period of actual construction each stretch out over several years. As a result, the expenditure of funds for a given project, once authorized, similarly is spread. Early year expenditures include those for Caltrans staff involved in design and engineering and for right-of-way acquisition. Later expenditures involve payment to contractors for actual construction work performed. Finally, as a general feature of the program, the consequences of decisions made at one point in time normally are not realized until several years later, and the program does not lend itself to sudden expansion or contraction.

A second basic characteristic of the highway program is that it is largely federally funded. State tax revenues are matched against federal-aid which becomes available to California on a year-by-year basis. If all federal-aid is to be captured, the utilization of state resources must be carefully scheduled over a period of years to correspond to the availability of federal-aid. In recognition of the "lead times" involved in project development and construction, federal apportionment for any given year is available for obligation over a four-year period.

The fact that the highway program is for the most part a capital outlay program has several implications for the way in which resources are budgeted and the way in which expenditures take place. These implications do not appear to be understood in the Auditor-General's report. More seriously, the importance of multi-year programming as a device to maximize federal-aid and to stabilize Department and industry operations appears to be totally ignored. These points will be explained further below.

C. Comments on specific sections of the report

1. "Discrepancies in budget reports"

We agree that Caltrans' budgets and other fiscal operations are complex, cumbersome, and difficult to understand. A recent memo from the Director to staff took note of this situation and asked staff to improve and clarify the budget system. We concur also that, insofar as this is possible, the Caltrans budget should be prepared in a format consistent with those of other departments included in the Governor's Budget. This objective has been largely accomplished (for the first time) in the just completed 1977-78 state highway budget. As explained below, however, there are certain basic aspects of the highway program which preclude its budgets being identical to those of other departments. The Auditor-General recognizes one of the factors -- a set of geographic and programmatic statutory restrictions applying exclusively to the State Highway Account -- but ignores the others.

It is correct that there are differences between the highway budget for a given year when it is reported first as a "proposed" budget, then as a "current" budget, and finally as a "prior" budget. These changes in reported budgets occur as a result of the process of obligating federal (and state) funds. As we noted in the introduction to this paper, federal apportionments are available for obligation over a four-year period. New apportionments become available each year. When we draw up a proposed budget we identify all new state revenues, all new federal apportionments, and the planned use of resouces. Resources that will not be obligated in the proposed budget year are handled as a reserve and are ultimately carried forward to subsequent years for obligation. When the proposed budget becomes the actual budget, it in turn is augmented by the amount of resources carried forward from previous years. This carrying forward of resources creates a "wave effect" on the budget for a given year as it evolves from a "proposed" to an "actual" to a "prior" budget, with the peak of the wave always showing in the "actual" budget.

We realize that the change in a given year's budget as it absorbs the wave can be misinterpreted as indicating a real change in program magnitude. In the 1977-78 budget we have, for the first time, shown as a resource the amount of carryover reserves from previous years to be obligated in that year. This action will reduce the wave effect on the 1977-78 budget when it becomes the actual budget.

As to the observations in the Auditor-General's report that actual cash disbursements during a given year do not relate solely to the budget for that year but also to the budgets for previous years, we point out that expenditures authorized under a capital outlay budget are intended to occur over a period of years. As the report points out, the Caltrans budget is intended primarily as an authorization for work. Given the extended period of time during which work on construction projects is carried out, it would be extremely difficult to develop the budget on a cash or expenditure basis. Our authority to begin advertising projects six months in advance of the budget year (and thus to begin spending on a budget prior to the budget year) also complicates a cash approach to budgeting.

The issue of the consistency of our accounting procedures is separate and apart from the issue of presumed "discrepancies" between the budget for a given year and cash disbursements during that year (as discussed above). We recognize that our accounting procedures need to be updated and standardized. Since the Auditor-General's opinion on our financial statements was issued in 1968, we have implemented the majority of his recommendations. We are continuing to make improvements to our accounting procedures. A complete overhaul of the system would, however, cost several million dollars and take a number of years to complete.

Finally, with regard to the accuracy of our estimates of project costs, our estimates historically have in fact been very close to actual costs. Insofar as we have over-estimated costs more often than underestimated them (on the average showing costs underruns of about 10 percent) we have exercised prudent and conservative judgment in committing the expenditure of taxpayers' resources. When underruns occur, they are immediately available for commitment to other projects.

2. "Inaccurate cash management system"

This section of the report, like the preceding section, evidences a lack of understanding of how the Caltrans program operates. Furthermore, the Auditor-General used an outdated set of data to draw the conclusion that cash forecasting by Caltrans has been inaccurate and from that to draw yet other untenable conclusions. In fact, this forecasting has been extremely accurate.

Contrary to statements in the report, Caltrans does not retain cash reserves at any given point in time in order to make cash expenditures at a later point in time on construction projects which are underway in the earlier period. Such a practice, as the Auditor-General points out, is not necessary because there is a continuing stream of federal and state revenues as contract payments come due. The

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Department's system of cash management is based on full recognition of the continuing future flow of revenues. The system is intended to and does serve precisely the purpose that the Auditor-General says it should serve: to estimate carefully future revenues by period of receipt and to time expenditures to correspond with these revenue receipts.

Essential to the full utilization of resources on the one hand and to the maintenance of solvency on the other hand, is accurate revenue and cash forecasting. Obviously, such forecasts are not made once and for all time but are continually updated as conditions change. Obviously also, such forecasting is most difficult when conditions affecting future cash levels are rapidly changing. The sole evidence presented in the Auditor-General's report to back up the assertion that the Department's cash forecasts have been inaccurate is a set of data from June 1975, when conditions affecting cash receipts were rapidly changing as a delayed result of the Arab oil embargo and its effect on state gas tax revenues. This evidence is erroneous. The correct data for this period indicate very accurate, not inaccurate, cash forecasting.

During the twelve-month period (October 1975 through September 1976) examined by the Auditor-General, Caltrans developed seven cash forecasts, in sequence each forecast superseding the earlier forecast to update for changed conditions. The Auditor-General has compared the <u>initial</u> forecast of cash lows in all future months of the twelve-month period to the lows actually experienced in those months and reaches the conclusion that experience varied from forecasts by an ever increasing amount, ending with a $174 million difference in the final month. Comparing, however, actual month-by-month experience with the forecast most recent to the month -- as should properly be done -- Caltrans' cash forecasts for the twelve-month period are seen to have been accurate within 10 percent, with a variation of $22 million at the end (see below). It was the series of updated forecasts, and not the single initial forecast, which was used by the Department for management purposes during the period.

COMPARISON OF ESTIMATED AND ACTUAL CASH LOWS
($ Millions)

Month	Actual*	Projected	Difference	Forecast Date
October '75	$ 29.6	$ 40.5	$ +10.9	September 1975
November	34.5	20.3	-14.2	"
December	33.2	21.9	-11.3	"
January '76	43.6	39.7	- 3.9	January 1976
February	85.6	73.6	-12.0	"
March	124.7	94.7	-30.0	"
April	156.6	154.2	- 2.4	April 1976
May	178.0	177.5	- 0.5	May 1976
June	184.7	172.9	-11.8	"
July	180.0	154.0	-26.0	"
August	186.9	179.4	- 7.5	August 1976
September	209.1	186.5	-22.6	"

*Per Auditor-General's Report

Following from its incorrect assertion that Caltrans' cash forecasts for the 1975-76 period were highly inaccurate, the Auditor-General's report states that this "inaccuracy" casts doubt on the Department's need, from a fiscal standpoint, to have curtailed operations. We have pointed out that the forecasts were, in fact, accurate. Furthermore, the necessity to curtail operations had been obvious, and had been discussed, for several years. On a constant dollar basis, highway spending had declined from approximately $1.4 billion in 1968 to $500 million in 1974, as a result of continuing inflation, a shift of federal-aid programs away from the state, and many other factors. Had major actions to reduce cash expenditures not finally been taken, the State Highway Account would have been insolvent by $20-$40 million in the fall of 1975.

Finally, we should note that current <u>high</u> cash balances are a direct result of our necessarily drastic actions to maintain solvency in late 1975 and are a result which were foreseen at that time. These balances will be drawn down in an orderly fashion in future years as expenditures flow to projects let to contract after the moratorium on advertising which was one of the actions taken during the cash crisis.

3. "Need for accurate and effective fiscal planning" and "Alternative solutions to the problem"

These sections of the report are largely repetitive of material found elsewhere in the report. We note again that Caltrans' budget differs from those of other departments not only because of the statutory restrictions under which the highway program operates but also because of its significant capital outlay component and because of federal funding procedures. We also point out (with reference to page 15) that supposed "philosophic differences" between the current and previous administrations have had no bearing whatsoever on the technical budgeting and cash management systems of the Department.

4. "Inflation and Department's actions"

The Auditor-General notes, correctly, in this section that inflation has an impact on the highway program more severe than its impact on most other state programs because revenue sources for the program do not have built-in inflation factors and because the rate of inflation itself is generally higher for construction than for consumer goods. Noting also that the rate of interest on funds which are not expended immediately is less than the rate of inflation, the report draws the conclusion that all resources should be expended as soon as possible after they become available. This kind of analysis, when applied to the highway program, neglects entirely the major factor governing the maximization of return on taxpayer resources used for the program -- the timely use of state tax revenues to match federal-aid over a several-year period. Assuming construction inflation at the rate of 7 percent per year and interest at 6 percent, any state tax revenues which are held for one year will decline in purchasing power by 1 percent. If, however, these funds are necessary in the <u>subsequent</u> year in order not to lose federal-aid, it is of much greater benefit to the state to delay their expenditure to that time because of their huge multiplier effect. State highway funds matched against federal highway funds return $6 to $7 for every $1 spent. The gain to the state taxpayer from a year's delay (if matching is involved in the second year and not in the first) is on the order of 600 to 700 percent, totally overwhelming the earlier 1 percent loss. Further, in today's fiscal environment, it is irresponsible to fund projects totally with state dollars that could later be used to lever federal dollars at a 6 or 7 to 1 ratio.

Caltrans' highway program, as pointed out several times previously, is designed and scheduled on a multi-year basis. Over the next six years, we project a decline in state gas tax revenues as federal energy efficiency standards for automobiles (now in law) go into effect. Although we project continuing increases in travel, automobiles will require less fuel and the net effect will be a decline in revenues from the gas tax. In order to continue to match all available federal-aid over this period without an increase in state taxes, some state revenues are planned to be carried over from the earlier years of the period to the later years. Any early-on loss of purchasing power will be offset many times over by the effect of federal matching in the later years.

5. "Recommendation 1"

We agree that, to the extent possible, budgetary information on the state highway program should be consistent with budgetary information on other state departments. Action in this direction should, however, be taken with full understanding of the special features of the highway program -- an understanding which is not evident in the Auditor-General's report.

6. "Delay in recovery of federal reimbursements"

As with any large business, Caltrans has a certain amount of receivables in the pipeline at any point in time. Between 80 and 90 percent of our receivables are collected on a monthly basis. Other receivables, primarily for right of way and preliminary engineering, are collected on a planned schedule throughout the year. Of the $110 million which is discussed in the Auditor-General's report, $55 million is in this latter category and is planned for liquidation by April 1977. This amount is a significant reduction from prior years when the total in this category generally approached $190 million. We agree that improvement on the processing of this type of receivable is needed, and we have planned for some time to collect all receivables on a monthly basis commencing with the implementation of the 1977-78 budget.

The balance of the $110 million ($55 million) was not collectable until enactment of the 1976 Highway Act which provided flexibility to update to current participation rates old agreements that had not been final vouchered. Approximately $34 million was tied to state agreements and $22 million to local. This flexibility did not create new or additional revenue but merely allowed the state to trade apportionment for cash. The earliest this trade could have been initiated was May of this year (any cash probably would not have been received until July).

Since it was during the very period that the Department was formulating its multiyear program and 1977-78 budget that the Federal rules were changed to allow such a trade, the appropriate timing of the trade was, along with many other factors, properly considered as part of the analysis going into the development of the program, the budget, and associated cash forecasts. Specific concerns regarding the trade were maintaining a balance between cash and apportionment over the six-year period, the use of consolidated Primary and Transition Quarter apportionment specifically, and consistency with our policy to maximize Federal participation in individual projects. After the analyses of these factors had been completed, Caltrans did apply in early October for the funds.

The amount of interest lost to California was much less than the $2 million cited in the Auditor General's report. (The money was undoubtedly drawing interest in the Federal Trust Fund.) This loss of interest was taken into consideration and deemed substantially less significant than the consequences of a decision made without sufficient information. Such a decision, if in error, could have resulted in California not matching $250-300 million of <u>future</u> Federal aid on a timely basis.

We note, with regard to statements about "impoundment" and "lowering expectations" in this section of the report, that we have developed a six-year highway program that <u>uses</u> all new and carryover resources, both state and Federal, for projects to be budgeted over the period. Based on the program, the Department will be matching all Federal aid in the year apportioned through 1982-83 <u>without new taxes</u>. Our approach provides a reasonably constant level of work for the construction industry each year, a level workload for Caltrans employees, and a return on investment (by the timely matching of Federal aid) which is far in excess of inflationary increases. To manage resources otherwise would result in either not matching Federal aid in future years or in a tax increase.

<u>7. "Recommendation 2"</u>

We certainly agree with the need to reduce or at least hold the line on local property taxes. However, we have great difficulty in understanding this particular recommendation. We will reserve comment until such time as the recommendation may be clarified by the Auditor General.

STATE OF CALIFORNIA

EDMUND G. BROWN JR., Governor

CALIFORNIA HIGHWAY COMMISSION
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AREA CODE (916) 445-3259

December 3, 1976

Mr. John H. Williams
Auditor General
Suite 750
925 L Street
Sacramento, CA 95814

Dear Mr. Williams:

Because of the shortage of time in which to respond to the draft Audit Report entitled "Deficiencies of the Budgetary and Cash Management Operations of the Department of Transportation," we have been unable to develop comments which could be adopted by the California Highway Commission as a body. I, as Chairman, have prepared the following comments and these comments have received the approval of the additional named Commissioners: Mr. Joseph F. Sinnott, Mr. Winston R. Fuller, and Mr. Ken Vetter.

We would like to express the appreciation of the membership of the California Highway Commission for the investigation by the Joint Legislative Audit Committee and the Auditor General into the financial operations of Caltrans. We concur in the findings.

The findings of the Committee corroborate the beliefs of the majority of the Commission that public funds have been manipulated and mishandled through poor forecasting of expenditures, deliberate overinflation of costs to build up a cash surplus and a concealment of the true cash balance situation. We believe there is a coincidence between these aberrations in management practice and the introduction of a new philosophy of hostility toward the auto user.

The members of this Commission have worked earnestly toward a planning program and a highway budget that would utilize all available funds in the most efficient use possible. The financial machinations which you have uncovered underscores the problems the Commission has experienced in carrying out their function.

We want to thank and congratulate the Audit Team for the discovery of $110 million in uncollected federal revenues. The deliberate decision not to collect these funds with the attendant loss of $2 million in interest raises a question of accountability and responsibility which should be pursued.

We are pleased to see that the Auditor General's report made note that the failure to expeditiously realize available Federal funds and the build-up of cash balances are both contrary to sound fiscal management and further noted that similar activity at the Federal level was regarded by the Court as unconstitutional because the Executive Branches of government were improperly usurped to serve a legislative function.

We concur in your conclusions that a legislative solution is desirable, though we differ somewhat on specifics. At a later date it is possible that the Commission or individual Commissioners may wish to recommend legislation toward such a solution.

Sincerely,

W. E. Leonard

WILLIAM E. LEONARD
Chairman

State Highways Operations Comparison
of 1975-76 Budgeted and Actual

	Budget Submitted January 10, 1975	Budget Submitted January 10, 1976	Actual
	(In Millions of Dollars)		
Source of Funds			
State highway users taxes	$ 485.9	$ 511.8	$ 510.0
Federal aid	432.6	778.0	466.0
Other	57.8	69.7	52.4
Total	$ 976.3	$1,359.5	$1,028.4
Expenditures and Encumbrances			
Maintenance and administration	$ 281.5	$ 224.4	$ 205.7
Capital outlay	541.6	751.1	434.3
Local assistance	153.2	384.0	83.0
Total	$ 976.3	$1,359.5	$ 723.0

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