California State Auditor

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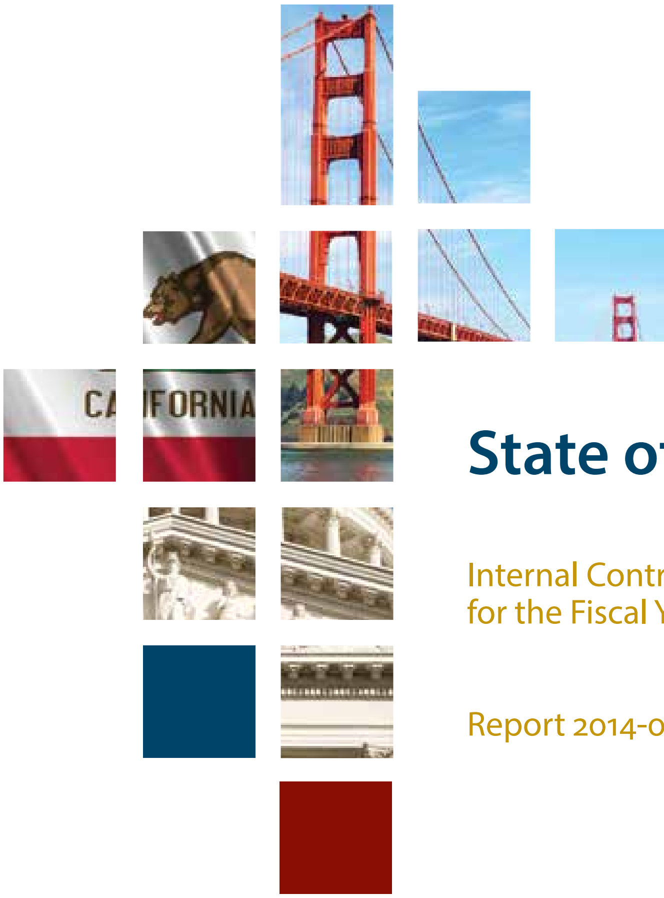

State of California

Internal Control and Compliance Audit Report for the Fiscal Year Ended June 30, 2014

Report 2014-001.1

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California State Auditor

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

March 26, 2015 2014-001.1

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

Dear Governor and Legislative Leaders:

As required by California Government Code, Section 8543 et seq., the State Auditor's Office presents its audit report concerning our review of the State of California's internal controls and compliance with state regulations for the year ended June 30, 2014.

This report concludes that the State continues to experience certain deficiencies in its accounting and administrative practices that affect its internal controls over financial reporting. We identified four deficiencies in internal control over financial reporting that we consider to be material weaknesses, and one other deficiency that we consider to be significant. Deficiencies in the State's internal control system could adversely affect its ability to provide accurate financial information.

Respectfully submitted,

JOHN F. COLLINS II, CPA
Deputy State Auditor

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

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

Independent Auditor's Report

The Governor and the Legislature of the State of California

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated March 19, 2015. Our report includes a reference to other auditors who audited the financial statements of the following, as described in our report on the State's financial statements:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 79 percent of the assets and deferred outflows and 30 percent of the revenues of the business-type activities.

- The University of California and the California Housing Finance Agency that represent 93 percent of the assets and deferred outflows, and 93 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- The Safe Drinking Water State Revolving fund, that represents 15 percent of the assets and deferred outflows, and 6 percent of the additions, revenues, and other financing sources of the Environmental and Natural Resources fund, a major governmental fund.

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

- The Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control, and the 1943 Veterans Farm and Home Building funds, that represent 85 percent of the assets and deferred outflows, and 58 percent of the additions, revenues, and other financing sources of the aggregate remaining fund information.

- The discretely presented component units noted above.

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors. The financial statements of the Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Lottery, the Water Resources, and the 1943 Veterans Farm and Home Building funds were not audited in accordance with *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the State of California's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the following deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be material weaknesses–items 2014-1 through 2014-4.

A *significant deficiency* is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiency described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements to be a significant deficiency–item 2014-5.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of California's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Entity's Responses to Findings

The State of California's responses to the findings identified in our audit are described in the accompanying section on Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. The State's responses were not subjected to the auditing procedures applied in the audit and, accordingly, we express no opinion on them.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the State's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

CALIFORNIA STATE AUDITOR

John F. Collins II

JOHN F. COLLINS II, CPA
Deputy State Auditor

March 19, 2015

Schedule of Findings

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2014

Summary of Auditor's Results

Financial Statements

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

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

DEPARTMENT OF EDUCATION

Reference Number: 2014-1

Condition

The Department of Education's (Education) Federal Trust Fund liabilities and expenditures were understated by $1.3 billion for fiscal year 2013–14. Specifically, Education incorrectly reduced its liabilities and expenditures by $1.3 billion when it submitted its generally accepted accounting principles (GAAP) adjustments to the State Controller's Office (Controller's Office).

This understatement arose due to confusion over a revision the Department of Finance (Finance) made to department reporting requirements for the *Report of Expenditures of Federal Funds* (Report 13). In September 2013, Finance revised *State Administrative Manual* section 7974, adding a requirement that payments to sub-recipients be recorded on a cash basis on the Report 13. Finance uses the information on the Report 13 to prepare the Schedule of Expenditures of Federal Awards.

In January 2015, Education submitted corrected information to the Controller's Office.

Criteria

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

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

Recommendation

Education should revise its procedures to ensure that the GAAP entries it sends to the Controller's Office allow it to prepare financial statements in accordance with GAAP.

Department's View and Corrective Action Plan

Education concurs with this finding; however, the condition was the result of incorrect and conflicting information that was communicated from control agencies as explained above. The reporting requirements that were disseminated to state agencies, ultimately leading to this finding, have been discussed with the control agencies and resolved.

DEPARTMENT OF HEALTH CARE SERVICES

Reference Number: 2014-2

Condition:

The Department of Health Care Services (DHCS) understated Medi-Cal expenditures and revenues for fiscal year 2013–14 in the Federal Trust Fund by $626.2 million. Additionally, DHCS overstated Medi-Cal expenditures for fiscal year 2013–14 in the General Fund by $389.2 million. For budgetary purposes, DHCS reports Medi-Cal expenditures on a cash-basis. Generally accepted accounting principles (GAAP), however, require governmental funds to be accounted for on a modified accrual basis. Specifically, expenditures must be recognized in the accounting period in which they are incurred. As a result, DHCS must prepare GAAP adjustments to convert its budgetary reports to the modified accrual basis for proper presentation in the State's Comprehensive Annual Financial Report. The following sections provide more detail about DHCS' misstatements by program.

Overstated Accruals for the Fee-For-Service Health Care Delivery System and for Noncontract Hospital Inpatient Cost Settlements

DHCS overstated expenditures and related revenues by $455.5 million in the Federal Trust Fund and overstated expenditures by $455.5 million in the General Fund for the Fee-For-Service Health Care Delivery System (Fee–For-Service). DHCS uses a fiscal intermediary to process payments to health care providers for the medical care and services they deliver to Medi-Cal eligible patients. DHCS calculated its accrual using actual payment data and payment estimates. The overstatement occurred because DHCS double counted actual payments from early in the subsequent year when calculating the accrual. The Chief of DHCS' Base Estimates Unit explained that DHCS uploaded payment data files, from the fiscal intermediary, into its accrual spreadsheet twice, thereby doubling the amount of actual payments. DHCS added a record count verification step to ensure that it only loads payment data files once.

DHCS also overstated expenditures and related revenues by $116.2 million in the Federal Trust Fund and overstated expenditures by $116.2 million in the General Fund for Noncontract Hospital Inpatient Cost Settlements. DHCS initially pays a noncontract hospital an interim payment for the cost of services the hospital has delivered to Medi-Cal beneficiaries. The noncontract hospital then submits an annual cost report and DHCS pays it a tentative settlement amount. Finally DHCS audits the hospital's costs and completes a final cost settlement that results in either a payment to the hospital above the tentative settlement or a collection from the hospital for overpayments. In its accrual, DHCS included amounts that it had paid to hospitals by June 30, 2014 and that were thus already included in its financial statements. DHCS included an accrual for noncontract hospital cost settlements for the first time in its fiscal year 2013–14 Medi-Cal accrual, but it did not create written procedures related to calculating this portion of the overall accrual. As a result, DHCS overstated expenditures on a GAAP basis by accruing expenditures that it had already included in its budgetary basis statements.

Understated Accruals for Medi-Cal Managed Care Program

DHCS understated expenditures and related revenues by $1.2 billion in the Federal Trust Fund, and understated expenditures by $182.5 million in the General Fund for the Medi-Cal Managed Care program (Managed Care). Managed Care health plan providers help Medi-Cal beneficiaries find doctors, pharmacies and health education programs. In contrast to Fee-For-Service, Managed Care plan providers are paid a monthly rate for each individual enrolled with them. DHCS validates provider information and generates invoices for payment to Managed Care plans. DHCS uses its Capitation Management (CAPMAN) system to generate validated invoices for payment. To calculate the accrual, DHCS staff requested and used a query of CAPMAN data to estimate invoices to be generated through October 2014 for service periods on or before June 30, 2014. However, DHCS' query failed to include invoices generated by June 30, 2014 that had not yet been paid by fiscal year-end. This oversight caused DHCS to obtain an incomplete set of invoice data to use in preparing its accrual. According to the

Chief of the Capitation Payment Unit, DHCS did not provide written guidance to its staff on how to prepare the Managed Care accrual. Without documented processes to guide staff in preparing all accruals, DHCS risks materially misstating Medi-Cal accruals in the future.

Criteria:

California Government Code Section 12461 requires the State Controller's Office (Controller's Office) to issue an annual financial report that is prepared in accordance with GAAP. To prepare its financial report, the Controller's Office annually requests that departments submit GAAP-related adjustments for the funds they manage.

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

The Controller's Office provides guidance to departments on the preparation of their year-end financial statements in its Year-End Financial Reports Information GAAP Basis Manual (GAAP manual). According to the GAAP manual, agencies should accrue liabilities and related expenditures for services provided prior to June 30 that will be paid in the following fiscal year.

Recommendation:

To ensure its financial statements are properly presented at fiscal year-end, DHCS should:

- Ensure proper implementation of the updated accrual procedures it has established for the Fee-For-Service program.

- Develop written procedures to ensure it accrues only expenditures outstanding at year-end for Noncontract Hospital Inpatient Cost Settlements.

- Develop and document a process to ensure it accrues all unpaid expenditures related to the Managed Care program.

Department's View and Corrective Action:

Recommendation 1: DHCS agrees with the recommendation. Corrective action has been identified and Fiscal Forecasting implemented the second verification step in September 2014. As identified in the audit report, DHCS added a record count verification step to ensure that it only loads payment data files once. The analyst responsible for uploading the file into Fiscal Forecasting's database reviews the record count for reasonability. This step occurs earlier than the initial verification process of comparing the weekly checkwrite files to the monthly paid claims data files. The initial verification step occurs once the monthly paid claims file is available via the MIS/DSS system. The weekly checkwrite files for a given month are summed and compared to the monthly paid claims file.

Recommendation 2: DHCS agrees with the recommendation. DHCS Audits and Investigations will complete written procedures by April 17, 2015.

Recommendation 3: DHCS agrees with the recommendation. DHCS will develop and document a process to ensure it accrues all unpaid expenditures related to the Managed Care Program, no later than June 30, 2015.

DEPARTMENT OF HEALTH CARE SERVICES

Reference Number: 2014-3

Condition:

The Department of Health Care Services (DHCS) overstated expenditures in the General Fund and understated expenditures in the Nonmajor Governmental Funds by $448 million for fiscal year 2013–14. Within the Nonmajor Governmental Funds, DHCS understated expenditures in the Children's Health and Human Services Special (Children's Health Fund) and the Long Term Care Quality Assurance (Quality Assurance Fund) funds by $207 million and $241 million, respectively. Specifically, DHCS did not correctly account for Medi-Cal reimbursements in accordance with generally accepted accounting principles (GAAP). For budgetary purposes, DHCS reports Medi-Cal expenditures on a cash-basis. GAAP, however, requires governmental funds to be accounted for on a modified accrual basis. Specifically, expenditures must be recognized in the accounting period in which they are incurred. As a result, DHCS must prepare GAAP adjustments to convert its budgetary reports to the modified accrual basis for proper presentation in the State's Comprehensive Annual Financial Report.

DHCS accounts for both the gross premium tax and the sales tax on managed care plans in the Children's Health Fund. It also accounts for the long-term care quality assurance fees in the Quality Assurance Fund. The purpose of the Children's Health Fund is to finance the state's share of managed care payments for health care services. The purpose of the Quality Assurance Fund is to provide additional reimbursement to, and support quality improvement efforts of, program participants. Both funds are used to enhance federal participation in these programs. DHCS's Accounting Section management explained that the General Fund initially pays for program expenditures as they are incurred, and these two funds subsequently reimburse the General Fund for their share of the expenditures. For fiscal year 2013–14, DHCS properly accrued and reported revenues in the Children's Health Fund and the Quality Assurance Fund; however, it did not submit an adjusting entry to accrue the related reimbursements to the General Fund. This occurred because DHCS's procedures for determining which funds need an adjusting entry to comply with GAAP did not include steps to identify funds that accumulate revenues to reimburse other funds, such as the General Fund. By not accruing these reimbursements as required by GAAP, DHCS risks materially misstating expenditures in the General Fund and the Nonmajor Governmental Funds.

Criteria:

California Government Code Section 12461 requires the State Controller's Office (Controller's Office) to issue an annual financial report that is prepared in accordance with GAAP. To prepare its financial report, the Controller's Office annually requests that departments submit GAAP-related adjustments for the funds they manage.

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

The Controller's Office provides guidance to departments on the preparation of their year-end financial statements in its Year-End Financial Reports Information GAAP Basis Manual (GAAP manual). According to the GAAP manual, agencies should accrue liabilities and related expenditures for services provided prior to June 30 that will be paid in the following fiscal year.

GAFRS Section 1800 defines reimbursements as repayments from the fund responsible for a particular expenditure to the fund that initially paid for them. Reimbursements should not be displayed in the financial statements. The GAAP manual instructs agencies to record a reduction in expenditures for the reimbursed fund and to record an increase in expenditures for the reimbursing fund.

Recommendation:

To ensure its financial statements are properly presented at fiscal year-end, DHCS should:

- Report all activity for the governmental funds it manages on a modified accrual basis.

- Expand its accrual methodologies to ensure the effect of reimbursements on expenditures is reported in the appropriate fund.

Department's View and Corrective Action:

Recommendation 1: DHCS agrees with the recommendation and is currently in the process of updating the written procedures to ensure the reporting of all activity for the governmental funds managed are on a modified accrual basis. It is estimated the procedures will be written and implemented by April 30, 2015.

Recommendation 2: DHCS agrees with the recommendation and is currently in the process of updating the written procedures to expand the accrual methodologies to ensure the effect of reimbursements on expenditures is reported in the appropriate fund. It is estimated the procedures will be written and implemented by April 30, 2015.

DEPARTMENT OF TRANSPORTATION

Reference Number: 2014-4

Condition

The Department of Transportation (Caltrans) submitted fiscal year 2013–14 capital assets reports to the State Controller's Office (Controller's Office) that included material misstatements related to the highway infrastructure of the State of California (State) due to inadequate review within Caltrans' accounting division and programming logic errors on the part of Caltrans' information technology staff. Subsequent to its first submission of financial reports in August 2014, Caltrans submitted multiple revisions of its capital assets reports to the Controller's Office that continued to contain materially misstated information. Caltrans submitted a final version of its capital assets reports in January 2015. The final amounts for Caltrans' capital assets reported in the State's *Comprehensive Annual Financial Report* (*CAFR*) differed significantly from those in Caltrans' first submission. Compared to the final amounts, the first version understated the State's beginning infrastructure balance by $2.4 billion, understated its ending infrastructure balance by $1.6 billion, and overstated its net infrastructure additions by $802.1 million.

The two Caltrans funds primarily affected by beginning balance adjustments were the State Highway Account, whose infrastructure related balances increased $931.6 million, and the Transportation Congestion Relief Fund, whose infrastructure related balances increased $922.1 million. In both cases, the increase represents previously unreported infrastructure costs incurred in prior years. The adjustment was particularly significant for the Traffic Congestion Relief Fund, which previously reported just $9.4 million in infrastructure assets. Significant adjustments like these are an indication that Caltrans staff did not accurately identify all infrastructure costs in previous years.

Even though the chief of Caltrans' Service Transactions and Asset Reconciliation Section (section chief) stated that she performed reviews of Caltrans' capital assets reports before submission, Caltrans' accounting division still required assistance from the California State Auditor to identify and correct certain issues, some of which would have resulted in significant misstatements. For example, in one version Caltrans submitted a capital assets report to the Controller's Office showing that the State Highway Account had only $35.5 million in infrastructure additions for fiscal year 2013–14. After our office questioned the low level of additions, Caltrans submitted a revised capital assets report with $734.1 million in infrastructure additions, an amount more consistent with additions in recent years. Caltrans also submitted capital assets reports to the Controller's Office that increased completed infrastructure without similarly decreasing construction work in progress. Because infrastructure additions represent completed projects that have been deducted from the work in progress account, infrastructure additions and work in progress deductions should be closely aligned. Finally, Caltrans submitted a capital assets report that inappropriately presented beginning balance adjustments as additions and deductions to capital assets when the adjustments should have been presented as restatements to the beginning balance. Our identification of such issues generally required no more than a cursory review of Caltrans' capital assests reports and underscores the need for Caltrans to improve its review procedures.

According to the section chief, programming logic errors on the part of Caltrans' information technology staff also contributed to the need for report revisions. For instance, she explained that the low level of infrastructure additions noted previously was caused by an error in computer programming logic. Accounting division staff failed to detect the error because they did not perform a reasonableness check of the capital assets reports created by information technology staff. A thorough review of information technology staff's work is important because they prepare the reports that underpin Caltrans' infrastructure reporting.

Given the magnitude of the State's infrastructure, even seemingly minor programming errors can contribute to significant misstatements. Caltrans' reported infrastructure constitutes a large majority of the State's capital assets. Specifically, Caltrans' ending balances of land, state highway infrastructure, and construction in progress totaled about $91 billion, representing 73 percent of the State's net capital assets balance of $125 billion at June 30, 2014. Accordingly, misstatements of capital assets by Caltrans can significantly affect the State's overall capital assets reporting.

Criteria

Sections 1400.105 through 108 of the Codification of Governmental Accounting and Financial Reporting Standards apply to governments using the modified approach for reporting infrastructure assets. These sections allow a government to avoid depreciating its infrastructure assets as long as it maintains the assets at or above a condition level established and disclosed by the government. The State uses this approach in accounting for its highway system. It therefore expenses all costs used to maintain its infrastructure assets and only records costs as capital assets if they have increased the capacity or efficiency of the infrastructure system.

The *Controller's Year-End Financial Reports Procedure Manual* (*Procedure Manual*) indicates that beginning balances must agree with the prior year's ending balances except for restatements of the beginning balance for unreported or misclassified items. Capital assets reports with such restatements are to include a footnote that includes a description and the amount of the adjustment. The *Procedure Manual* also indicates that the addition column of capital assets reports should only be used for assets acquired or internally generated during the current fiscal year.

The *State Administrative Manual* provides guidelines indicating that when an internally built asset is completed, the relevant asset account should be increased and construction work in progress should be decreased.

Recommendations

Caltrans should develop robust written procedures for each Caltrans unit involved in reporting the State's capital assets and should regularly review and update these procedures. Since Caltrans' information technology staff plays an important role in the preparation of Caltrans' capital assets reports, Caltrans' procedures should provide clear instructions to them on how to accurately produce financial information.

Caltrans should also provide training to its supervisory staff to ensure that financial information reported to the Controller's Office is materially correct. To prevent multiple submissions to the Controller's Office containing material misstatements, Caltrans should conduct a thorough supervisory review of its capital assets reports. Furthermore, Caltrans should develop and analyze trendlines or other analytics with regard to components of capital assets within its capital assets reports. This would provide additional insight as to the reasonableness of its overall capital assets reporting. For example, Caltrans could perform a trend analysis to determine whether the year's capital assets activities are consistent with recent historical data or could compare report amounts with Caltrans' expectations of capital assets activities, based on its knowledge of the projects it manages.

Department's View and Corrective Action Plan

Caltrans will examine and expand its current written procedures for reporting infrastructure capital assets, including a focus on addressing shortcomings identified by the audit report. Furthermore, Caltrans will annually re-evaluate the criteria used for capitalizing these assets. Caltrans will establish checklists for both staff and supervisors as a guide for the preparation, review and approval for the reports. The checklist will include procedures for trend analysis to ensure capital asset reporting is reasonable and consistent with historical reporting. Multiple levels of management will review the reporting before it is submitted to the Controller's Office. Caltrans will follow a formal written change request process to define and document instructions and criteria provided to its Information Technology staff for producing the financial information needed for the reporting. These improvements will be adopted by June 30, 2015. Caltrans will engage the California State Audit staff periodically as procedures are developed and implemented to ensure the corrective actions are satisfactory.

DEPARTMENT OF TRANSPORTATION

Reference Number: 2014-5

Condition

The Department of Transportation (Caltrans) understated its fiscal year 2013-14 liabilities and expenditures by $249 million for the Federal Trust Fund. On a budgetary/legal basis, encumbrances are recognized in Caltrans' Federal Trust Fund records when commitments related to unperformed contracts for goods or services are made. However, according to generally accepted accounting principles (GAAP), encumbrances should not be recognized as liabilities or expenditures until the goods or services are received. Caltrans appropriately submitted an entry to the State Controller's Office (Controller's Office) to eliminate encumbrances to bring its financial information in line with GAAP. However, Caltrans' entry improperly included $249 million for valid obligations for goods or services which had already been received, resulting in an understatement. After we pointed out this error, Caltrans submitted an appropriate adjustment to the Controller's Office.

Criteria

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

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

Recommendation

To ensure its financial statements are properly presented at fiscal year-end, Caltrans should strengthen its review process to ensure that the Federal Trust Fund entry it submits to the Controller's Office to remove encumbrances does not include valid obligations.

Department's View and Corrective Action Plan

Caltrans employees who prepare the Federal Trust Fund GAAP entries will be reminded to follow existing written procedures and use existing checklists for encumbrances and obligations. Furthermore, Caltrans supervisors who review and approve the Federal Trust Fund GAAP entries will be reminded to ensure procedures are followed and checklists are completed. This will occur by March 31, 2015.

Date: March 26, 2015

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