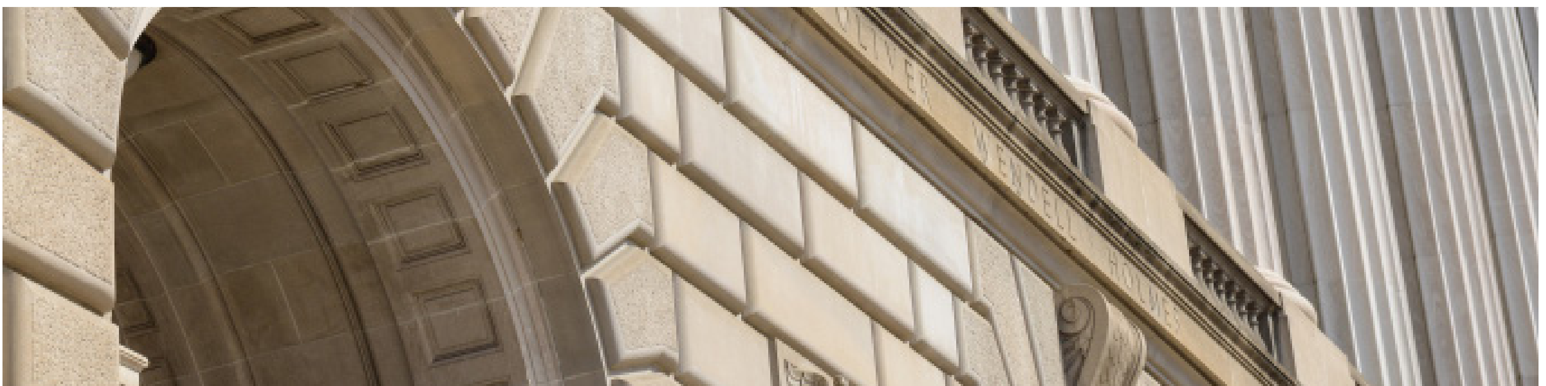
State of California

Internal Control and Compliance Audit Report
for the Fiscal Year Ended June 30, 2018

July 2019

REPORT 2018-001.1



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Elaine M. Howle *State Auditor*

July 19, 2019
2018-001.1

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 Government Code section 8543 et seq., the California 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, 2018.

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 based on our audit of the State's basic financial statements. We identified three 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,

MICHAEL S. TILDEN, CPA
Deputy State Auditor

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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, 2018, and the related notes to the financial statements, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated May 29, 2019. Our report includes a reference to other auditors who audited the financial statements of the following, as described in our report on the State of California's financial statements.

Government-wide Financial Statements

- Certain governmental funds that, in the aggregate, represent one percent of the assets and deferred outflows, and less than one percent of the revenues of the governmental activities.
- Certain enterprise funds that, in the aggregate, represent 75 percent of the assets and deferred outflows, and 54 percent of the revenues of the business-type activities.
- The University of California and the California Housing Finance Agency that represent 92 percent of the assets and deferred outflows, and 94 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- 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 Revolving, the Safe Drinking Water State Revolving, and the 1943 Veterans Farm and Home Building funds, that represent 85 percent of the assets and deferred outflows, and 53 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 State Lottery, 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 of California's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of California'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 section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements, we did identify 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 deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as items 2018-1, 2018-2 and 2018-3 to be material weaknesses.

A significant deficiency is a deficiency, or a 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 deficiency described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as item 2018-4 to be a significant deficiency.

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*.

State of California's Response to Findings

The State of California's responses to the findings identified in our audit are described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements. The State of California's responses were not subjected to the auditing procedures applied in the audit of the financial statements 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 of California'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 of California's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

CALIFORNIA STATE AUDITOR

MICHAEL S. TILDEN, CPA
Deputy State Auditor

May 29, 2019

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2018

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

STATE CONTROLLER'S OFFICE

Reference Number: 2018-1

Condition:

The federal government requires California to publish its Single Audit report, which includes the Comprehensive Annual Financial Report (CAFR), within nine months of the end of the fiscal year, or by March 31, 2019; however, the State Controller's Office (State Controller) did not issue the State's CAFR until June 2019, more than two months after it was due. One reason for the CAFR's delay was that the State Controller did not implement a major new accounting and financial reporting standard for postemployment benefits other than pensions (OPEB) in a timely manner. It also chose a methodology for allocating OPEB liabilities to state funds in a manner that is inconsistent with how the State pays for OPEB benefits, which created the risk of a material misstatement to the CAFR. Furthermore, the State Controller incorrectly excluded from the CAFR the net pension liability, related amounts, and disclosures for California Superior Courts (trial courts) for fiscal years 2014–15 through 2016–17 despite reporting the other financial activities of the trial courts. The State Controller's decision in April 2019 to begin including this pension information in the State's financial statements further delayed the release of the CAFR.

The State Controller Did Not Implement a New Accounting and Financial Reporting Standard in a Timely Manner

The State Controller's two-month delay in publishing the CAFR was due, in part, to its delay in implementing a new OPEB standard. The Governmental Accounting Standards Board's Statement Number 75 (GASB 75), *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, establishes accounting and financial reporting standards for OPEB effective for the State's fiscal year 2017–18. The State Controller initially planned to release its *Schedule of Pensionable Compensation and Schedule of OPEB Amounts* (OPEB report) on September 25, 2018. However, the State Controller subsequently revised its timeline for implementing this standard three times and ultimately released this report on January 31, 2019; four months later than planned. The late release of this report delayed the publication of several stand-alone financial statements that needed to be incorporated into the CAFR, which in turn contributed to the late release of the CAFR.

The State Controller's OPEB report provided other external auditors who audited the stand-alone financial statements of certain department's information they needed to complete their audits. Departments also used information from the OPEB report to address some of the requirements of GASB 75 in their own financial statements. All of these departments are required to provide their financial statements to the State Controller for incorporation into the CAFR, and without this information the State's financial statements would not be complete. The State Controller set a deadline of November 1, 2018, for departments to submit their statements to allow it enough time to incorporate these stand-alone financial statements into the State's CAFR. However, these departments were not able to meet this deadline because the State Controller did not release the OPEB report until January 31, 2019. Consequently, several of these departments did not submit their stand-alone financial statements to the State Controller until late March or early April 2019, which delayed the release of the State's CAFR because the State Controller's staff needed time to incorporate this information into the CAFR.

In addition, the State Controller did not share with us its methodology for allocating the State's net OPEB liability and related amounts to various state funds in a timely manner. In June 2018, we asked the State Controller to provide us with a description of its allocation methodology, including the underlying rationale and key assumptions, in sufficient detail for us to determine whether the allocation methodology complied with generally accepted accounting principles (GAAP). However, the State Controller provided us only partial information in September 2018 and followed up with additional information in late October 2018. We reviewed the allocation methodology and relayed certain concerns we had to the State Controller. Subsequently, in late November 2018, the State Controller notified us it had decided not to use that allocation methodology. According to the policy manager of the State Controller's State Accounting and Reporting Division, the State Controller determined that its initial methodology was unduly complex and too expensive to complete. The State Controller decided to adopt a different method of allocation, which we describe in the next section, and forwarded us its draft OPEB report based on that new methodology on December 21, 2018.

The State Controller's Method of Allocating the OPEB Liability to State Funds Is Flawed

The State Controller's method of allocating OPEB liabilities to state funds does not align with the State's primary method of paying for OPEB benefits. Currently, the State pays for these benefits as they become due using the pay-as-you-go method. Specifically, the General Fund initially pays health and dental insurance premiums for state retirees and their dependents, and is subsequently reimbursed by other funds for a portion of these costs based on their proportionate share of the healthcare and dental costs of active employees. However, the State Controller's allocation methodology is based on the State's recent efforts to prefund its OPEB liability by making financial contributions to OPEB plans based on pensionable compensation (the portion of employee pay used to calculate retirement benefits). However, these contributions cannot be used to pay benefits until the earlier of July 2046, or when an OPEB plan is fully funded. Consequently, the allocation method that the State Controller used resulted in some funds recording a net OPEB liability in a larger or smaller amount than what they will actually have to pay.

Because the State Controller's allocation methodology does not align with the State's primary method for paying OPEB expenses, we asked the State Controller to provide us with an analysis demonstrating that its methodology would not cause a material misstatement to the CAFR (in other words, that it would not materially misstate the net OPEB liability and related amounts of any state funds). However, the State Controller chose to continue with its approach without providing this information to us. As a result, we had to perform this analysis after we received the State Controller's OPEB report on December 21, 2018, in order to assess the risk to the fiscal year 2017–18 CAFR. Although the State Controller's method of allocation did not result in a material misstatement, the risk remains for future years if it does not change its methodology to better align with the State's method of paying for OPEB benefits.

The State Controller Omitted the Net Pension Liability for Trial Court Employees from the State's CAFR for Several Years

When the State Controller implemented GASB Statement Number 68 (GASB 68), *Accounting and Financial Reporting for Pensions*, it inappropriately excluded the net pension liability, related amounts, and disclosures for trial courts from its fiscal year 2014–15 CAFR, and continued to exclude this information for fiscal years 2015–16 and 2016–17. Prior to implementing this

new accounting standard, the State Controller had been reporting other financial information for the trial courts in the State's CAFR for many years. However, when it implemented GASB 68 the State Controller decided to exclude the net pension liability and related amounts from the CAFR while continuing to report the other financial activities of the trial courts. According to the chief of the State Controller's State Accounting and Reporting Division, in determining whether to recognize the net pension liability and related amounts for the trial courts, the State Controller focused on the flow of payroll to trial court employees. Because the State does not issue paychecks to trial court employees through its centralized payroll system, the State Controller decided not to recognize this activity until further research could be performed. However, this was not the appropriate criteria for making this decision because it did not comply with GAAP, and as described below, the State Controller apparently did not conduct this additional research until very recently.

The state of California is required to report the financial information of the State in its CAFR, including the financial activities of all organizations that are considered part of the "primary government" based on specific criteria contained in GAAP. Thus, if an organization such as the trial courts is deemed to be a part of the primary government based on this criteria, then all of its financial activities should be reported in the State's CAFR. During the latter stages of its preparation of the State's CAFR for fiscal year 2017–18, the State Controller analyzed the nature of the trial courts using this criteria and determined they are part of the primary government. The State Controller began to gather the information required to report the pension liability and related disclosures in April 2019, which further delayed the release of the CAFR. Ultimately, the State Controller incorporated the $1.8 billion net pension liability, related amounts, and disclosures for 22 trial courts that participate in county public employee retirement systems into its fiscal year 2017–18 CAFR. The State Controller plans to include the net pension liability, related amounts, and disclosures for the remaining trial courts that participate in county plans administered by the California Public Employees' Retirement System in future years.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards Section 1500 states that the long-term liabilities directly related to and expected to be paid from proprietary and fiduciary funds should be included in the accounts of such funds. These are specific fund liabilities, even though the full faith and credit of the governmental unit may be pledged as further assurance that the liabilities will be paid. All other long term debt of the government is general long-term debt and should not be reported as liabilities in governmental funds but should be reported only in the governmental activities column in the government-wide statement of net position.

Governmental Accounting Standards Board's Statement Number 75 states that if a primary government and its component units provide OPEB through the same single-employer or agent OPEB plan, each government should apply the cost sharing requirements of GASB 75 as if it were a cost-sharing employer in its stand-alone financial statements. The cost sharing requirements state that a liability should be recognized for each employer's proportionate share of the collective net OPEB liability in a manner that is consistent with the manner in which contributions to the OPEB plan are determined.

Governmental Accounting Standards Board's Statement Number 68, as amended, requires governments to report a net pension liability, other pension amounts, and related note disclosures for the pension benefits provided to employees.

Governmental Accounting Standards Board's Codification 2100 states that the financial reporting entity includes the primary government and all of the organizations that make up its legal entity. If an organization is part of the primary government, its financial data should be included with the financial data of the primary government.

Recommendations:

To effectively implement new standards, the State Controller should develop the following:

- Sound methodologies for implementing new accounting and reporting standards; and, it should promptly share those methodologies, including the underlying rationale and any key assumptions, with all relevant parties.
- Realistic timelines and project management protocols to ensure that it implements future standards in a timely manner.

The State Controller should revise its method for allocating the State's net OPEB liability and related amounts to state funds in a manner that better aligns with the State's primary method for paying OPEB expenses, or develop a mechanism for ensuring that the resulting misstatement to the State's CAFR does not become material.

The State Controller should incorporate the net pension liability, related amounts, and disclosures for the remaining trial courts into its fiscal year 2018–19 CAFR.

Department's View and Corrective Actions:*

SCO Response—Condition

The State Controller's Office (SCO) acknowledges that the State's Comprehensive Annual Financial Report (CAFR) was issued more than two months later than in previous years. The delay was the result of a number of factors, not limited to other postemployment benefits (OPEB) and California Superior Courts' (trial courts) pension reporting.

SCO met regularly with staff from the California State Auditor's Office (CSA) from October 2018 through May 2019. During these CSA and SCO Status Meetings, several outstanding items that delayed the publication of the CAFR were identified.

The Department of Health Care Services (DHCS) is regularly audited by CSA. The audit is mainly focused on Medi-Cal and other health care programs and DHCS was not waiting for OPEB information in order to complete its Fiscal Year (FY) 2017-18 financial statements. Last year, SCO was notified that the audit work of DHCS was concluded in March 2018. This year, SCO was notified CSA would conclude its audit of DHCS in April 2019. After reviewing all the DHCS entries provided by the department and CSA, it was determined that Health Care Related Programs was considered a major governmental fund and would need to be presented as a separate opinion unit in the CAFR. This change required adding descriptions and disclosures in the CAFR, revising table displays and formatting in the publication, and updating work papers and procedures. (1)

* California State Auditor's comments on the State Controller's response begin on page 14.

CSA conducted an audit of the financial statements of the Board of Governors of the California Community Colleges (BOG), which began using the Financial Information System for California (FI$Cal) in FY 2017–18. BOG experienced difficulties in generating FI$Cal financial statements for CSA to audit and submitted estimated year-end reports to SCO. CSA considered BOG to be a material department and therefore, needed to conduct a thorough review of the estimated reports to be able to assert that the submitted reports would not cause a material misstatement in the CAFR. CSA informed SCO in late April 2019, that its review would not require adjustments to the estimated amounts. (2)

Chapter 50, Statutes of 2017 (Senate Bill 84), required the Department of Finance (DOF) to allocate a one-time supplemental pension payment to the California Public Employees' Retirement System (CalPERS) to various funds that contribute to CalPERS. SCO provided DOF's initial contribution allocation, and the SCO's methodology for prorating the Surplus Money Investment Fund interfund loan amongst hierarchies, to CSA in April 2018. At (3) that time, SCO pointed out a few items that needed to be resolved between DOF and CSA. There were several discussions with DOF and CSA on how to appropriately allocate the contributions that resulted in DOF revising the contribution allocation. In early February 2019, CSA approved DOF's revised methodology and indicated SCO could move forward with its work. In mid-February 2019, SCO posted the entries based on DOF's allocation and provided documentation to CSA. During subsequent meetings from March to May 2019, SCO asked for updates on CSA's review. CSA provided final feedback on the work in May 2019. (3)

During CSA's review of the Contingent Liability information provided by the California Attorney (4) General's Office (AG), CSA expressed concerns with the language in the AG's response. There were subsequent discussions with both offices to determine if revisions to the language would meet CSA's audit standards. The issue between AG and CSA was not resolved until May 2019. (4)

The Department of Parks and Recreation (DPR) experienced issues reporting its capital asset balances to SCO for FY 2017–18. DPR's reports generated several questions from both CSA and SCO. CSA conducted a review of DPR's capital assets and was unable to reconcile the current year amounts in FI$Cal with prior year legacy balances based on the information provided by DPR. In May 2019, CSA notified SCO that it had completed the review of DPR's capital assets. Waiting until this capital asset issue was resolved delayed SCO's work on capital assets and depreciation. (5)

The CSA finding asserts that the methodology SCO used to allocate OPEB liabilities to State funds creates a risk that a material misstatement to the State's CAFR could occur. However, later in the finding, CSA states the allocation did not result in a material misstatement in the (6) FY 2017–18 CAFR. This was the first year of implementation of Governmental Accounting Standards Board Statement Number 75 (GASB 75), and SCO had to work with the most complete and accurate data available at the time. With the constraints on time and data accessibility, SCO moved forward with what it believed was a reasonable and rational approach, that could be supported by source documents, in allocating the State's OPEB liability. SCO is not opposed to re-evaluating its allocation methodology in future years when additional (7) information becomes available.

SCO Response—The State Controller Did Not Implement a New Accounting and Financial Reporting Standard in a Timely Manner

SCO began meeting with its actuary and expert accounting consultant in October 2016 to develop its methodology for allocating the net OPEB liability to agencies and funds. In April 2018, SCO met with CSA and discussed its intention to allocate the net OPEB liability (8)

by splitting the liability between active and retired members using the Actuarially Accrued Liability (AAL). CSA provided limited feedback at that time, but did informally state that SCO's proposed allocation methodology appeared reasonable. In early August 2018, SCO provided CSA with its General Introduction for the GASB 75 Methodology. As support for the introduction, SCO included specific examples of the calculations to split the liability between active and retired members. SCO did not receive any direct feedback from CSA regarding the General Introduction until early November, when CSA provided a formal response that it did not take exception to the proposed allocation methodology. (9) Subsequently, in mid-November, SCO received feedback from CSA that in order to execute the liability split methodology, the actuarial valuation would need to be revised to include a "hybrid" group (employees who are (10) currently active, but will retire without the benefit of prefunding OPEB contributions). After SCO consulted with its actuary regarding the feasibility of performing such calculations, the SCO State Accounting and Reporting Division Policy Manager communicated to CSA that adding this hybrid group to the actuarial valuation would make the liability split approach unduly complex and expensive. This left SCO in the position of needing to utilize the best available information in order to move the implementation forward expediently. SCO ultimately opted to utilize pensionable compensation as a means of allocation because it was the most accessible information available at that time, and met SCO's criteria of being attributable to agencies and funds as well as to the State's collective bargaining groups.

While certain circumstances beyond the control of SCO delayed the completion of some preliminary work and necessitated revisions to the timeline for the Schedule of Pensionable (11) Compensation and Schedule of OPEB Amounts (OPEB report), SCO clearly communicated this to CSA during regularly scheduled bi-weekly GASB 75 implementation meetings from April through September 2018. Upon the submission of work by SCO, CSA's unresponsiveness and (11) lack of timely and substantive feedback significantly hindered progress toward the completion of the OPEB report. The average turnaround time for feedback on information that SCO formally provided to CSA was over 75 days. For example, SCO provided CSA with its Pro Rata (11) methodology and allocation calculations on September 10, 2018. On October 16, 2018, more than a month later, CSA requested a formal walkthrough of this information. Ultimately, (11) CSA did not provide formal feedback on this information. Overall, CSA did not provide formal feedback to SCO for more than 50% of the OPEB transmittals submitted during the (11) implementation process.

SCO Response—The State Controller's Method of Allocating the OPEB Liability to State Funds is Flawed

SCO explored a number of different allocation methods that took into consideration the State's "long-term contribution effort," as prescribed by the cost-sharing guidance in GASB 75, paragraph 59. As previously mentioned, the initial allocations SCO provided to CSA took into consideration both the pay-as-you-go contribution amounts attributable to the State's payment of current retiree benefits, as well as the prefunding contribution amounts into the State's OPEB trust. Due to the aforementioned delays in obtaining feedback regarding SCO's initial allocation (12) methodology, and CSA's ultimate rejection of this methodology, SCO adjusted its approach to an allocation based entirely on pensionable compensation.

The State's OPEB plan is comprised of 25 bargaining units (BUs) with different member characteristics that factor into the calculation of each BU's distinct net OPEB liability. SCO determined through consultation with its actuary that in allocating the State's collective net OPEB liability, it was essential to acknowledge the separate valuations of each individual BU. The State's pay-as-you-go contribution amounts were not available by both agency (13) and BU. Additionally, prefunding contribution information by agency and BU for FY 2016–17

was not fully developed or reliable for the purposes of the allocation. However, pensionable compensation was available and met the criteria of being allocable by both agency and BU. Pensionable compensation is the primary basis by which the OPEB prefunding contributions by active members are determined (Government Code sections 22940–22944.5), and these prefunding contributions and the investment earnings thereon represent the State's strategy to reduce the total net OPEB liability. ⑬

SCO compared the results of the pensionable compensation allocation to its initial allocated amounts, and in most cases, these differences were not significant. ⑭ In addition, SCO discussed the pensionable compensation allocation approach in detail with all of the audited agencies and their external auditors, identifying the differences between this approach and SCO's initial approach. SCO received feedback indicating the method was understood, and the external auditors did not take significant exception to the allocation. ⑮ Ultimately, SCO's approach did not cause a material misstatement of the net OPEB liability and related amounts of any state funds. ⑯ Furthermore, none of the externally audited agencies received a modified opinion pertaining to SCO's allocation of OPEB. ⑰

SCO does not believe that its allocation methodology was flawed as it is reasonable and rational and pay-as-you-go contributions by BU are not available. ⑱ As with any first-year GASB implementation, SCO recognizes that adjustments to methodologies may be necessary in subsequent years. SCO takes exception to the fact that there is no quantified effect identified within this audit finding, and furthermore, CSA did not provide an analysis to support its assertion that SCO's allocation methodology could cause a material misstatement in future years. ⑲

SCO Response—The State Controller Omitted the Net Pension Liability for Trial Court Employees from the States' CAFR for Several Years

SCO acknowledges that prior to the 2017–18 CAFR net pension liability and related amounts for trial court employees were not reported or disclosed in the State's CAFR.

Contrary to the statement that "SCO decided to exclude net pension liability", when GASB 68 was being implemented, SCO realized that trial court employee reporting for pensions and OPEB was inconsistent. Trial court employees' pension information was not disclosed as required by GASB 27, Accounting for Pensions by State and Local Governmental Employers, effective from FY 1996–97 to FY 2013–14; whereas OPEB information was disclosed for trial courts beginning in FY 2007–08, as required by GASB 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. For nearly two decades, CSA did not identify this omission during its annual audits of the CAFR. ⑳

This issue is much more complex than CSA is indicating. Neither SCO nor CSA have records indicating why the trial courts' pensions were not included in the CAFR prior to the implementation of GASB 68. Legislation regarding the State's responsibility for trial courts and the benefits provided to trial court employees, and the actual application of that legislation did not clearly indicate whether the State or the counties would be responsible for reporting pension and OPEB liabilities. ㉑ The State provides the predominant funding for trial courts and that is why SCO has been reporting the "other financial information for trial courts" in the State's CAFR. SCO did not just "decide to exclude the net pension liability and related amounts" for the trial courts. During the GASB 68 implementation SCO followed its consultant's advice and performed its due diligence by determining how trial court employees were paid, reasoning that the entity that pays the employee should report the pension liability. SCO's

decision that the State was not required to report the trial court pension was not only based on who issued the employee's paychecks, but also on the fact that the pension benefits are provided through either pension plans administered by the county public employee retirement systems or county retirement plans administered by CalPERS. In addition, there was no clear indication that counties were not going to report trial court employees' pensions as part of their liability. SCO recognized that there was still an inconsistency between how pensions and OPEB were reported for trial court employees. In subsequent years, SCO refined its GASB 68 work on tasks such as performing employer responsibilities, obtaining and validating deferred employer contributions, calculating proportionate share, and ensuring that audited fiduciary funds reported net pension liability, while it continued to research the trial court pension issue. SCO was also working with the Judicial Council to determine what information was available to accurately report the trial court pension liability. During the summer/fall of 2018, SCO became aware that some counties were excluding the trial court employees' pension liability and obtained a legal opinion on whether trial court employees were State employees. SCO provided the legal opinion to CSA in January 2019 and 10 weeks later CSA advised us that this was not the appropriate criteria for making the decision and requested that SCO perform a reporting entity analysis. (21) (22) (22) (22)

As stated in the finding, the 2017–18 CAFR included the pension liability and related amounts and disclosures for 22 trial courts that participate in county public employee retirement systems. Beginning in July 2019, SCO will be meeting with the Judicial Council and county Auditor-Controllers to determine how to proceed with obtaining and reporting the pension liability and related amounts and disclosures for the 36 remaining trial courts that participate in county plans administered by CalPERS, with the goal of including this information in future CAFRs. SCO has also requested that CSA attend a meeting on July 2, 2019, with the Judicial Council and SCO and provide a complete list of its documentation needs and expectations for its audit of trial court pension information. (23)

SCO Responses to CSA Recommendations

- SCO agrees that methodologies developed for implementing new accounting and reporting standards need to be rational, reasonable, documented and shared in a timely manner. SCO consistently consults with its technical accounting and reporting consultants and other experts, such as SCO's OPEB actuary and GASB. SCO also contacted agencies and their external auditors to discuss the allocation methodology and none expressed significant exception to the methodology. Ultimately, SCO's approach did not cause a material misstatement of the net OPEB liability and related amounts of state funds. Furthermore, none of the externally audited agencies received a modified opinion pertaining to SCO's allocation of OPEB. SCO expects collaborative discussions with CSA on new implementation methodologies in order to receive meaningful feedback in a timely manner—both verbal (informal) and written (formal). Providing technical advice or feedback does not violate the auditor's independence standards as no assumption of management responsibilities occurs. Critical feedback does not interfere or change the initiation, scope, timing, or completion of the audit and no services are being provided that are intended to be used as SCO management's primary basis for making decisions that are significant to the subject matter of the audit. In fact, providing advice or assistance to an audited entity on accounting matters is generally part of the overall financial audit. (15) (16) (17) (24)

- SCO currently makes every effort to develop realistic timelines when implementing new standards, and will continue to do so in future implementations. A timeline is a living breathing document and may need adjustment as required when circumstances change, such as a lack of data or critical feedback being received before moving on to the next deliverable on the timeline. As noted above, providing technical advice or feedback does not violate the auditor's independence standards. There are multiple new accounting and reporting standards that will be issued in the next few years and it is imperative that CSA work collaboratively with SCO by having discussions and providing timely, pertinent, and critical feedback on the methodologies that will be developed. SCO has tried to engage CSA early on. For example, in the upcoming GASB 87 Leases implementation, in early May 2019, CSA was asked to look at a survey that was to be sent to agencies and CSA indicated it would need to be sent on a formal transmittal but could not commit to an estimated response time. SCO needs timely relevant feedback, and a delay in sending out the survey would greatly delay required work and necessitate a change to the implementation timeline. SCO currently employs project management protocols to manage the implementations. This includes timelines, listing deliverables, due dates for management review, transmittal dates to CSA, and required transmittal response dates from CSA. However, when transmittal responses are not received timely or at all, subsequent deliverable due dates are affected and in turn, the timeline must be adjusted. SCO fully understands, and takes seriously, the need for timely implementations of new accounting and reporting standards, as well as the need for a timely issuance of the State's CAFR. (24) (24) (25) (24)

- As previously indicated, SCO is willing to consider changes in its allocation methods as complete and accurate information becomes available. SCO plans to continue to conduct the necessary analysis to ensure allocated amounts for the audited agencies and funds do not result in material misstatements. (26) (27)

- As previously stated, SCO is working with the Judicial Council and county Auditor-Controllers to obtain the remaining 36 trial courts' pension information needed for inclusion in future year CAFRs.

Auditor's Comments on the State Controller's View

To provide clarity and perspective, we are commenting on the State Controller's response to our report. The numbers below correspond to the numbers we have placed in the margin of the State Controller's response.

(1) The State Controller's response grossly mischaracterizes this situation because there were a number of reasons that delayed the State Controller's determination that the Health Care Related Programs needed to be reported as a major fund in the CAFR. For example, the State Controller did not receive several audit reports until mid-March that impacted the calculations it had to perform to determine whether these programs met the criteria for being reported as a major fund. In addition, as we describe in rebuttal point 3, the State Controller contributed to the delayed completion of certain pension contribution allocations, which also impacted the reporting of the Health Care Related Programs. Furthermore, the State Controller elected not to post the Medi-Cal entries that the Department of Health Care Services submitted in the fall of 2018, until March 2019. This is contrary to its past practice of posting these entries as soon as they are received, and contributed to its inability to effectively monitor the magnitude of

the financial activities reported in the Health Care Related Programs fund. Because of these conditions, the State Controller did not recognize that the Health Care Related Programs met the criteria for being reported as a major fund until May 2019.

We agree that the Chancellor's Office experienced difficulties producing financial reports using FI$Cal which contributed to the State Controller's late publication of the CAFR, and we discuss this issue in our 2018-2 finding. However, the State Controller did not take a proactive role to help ensure that the Chancellor's Office could provide reliable financial reports in a timeframe that would not delay the publication of the CAFR. The financial activity of the Chancellor's Office is material to the State's overall financial reporting, and in November 2018 we informed the State Controller that the estimated reports provided by the Chancellor's Office were not reliable. Specifically, we advised the State Controller that the Chancellor's Office was still trying to reconcile its accounting records and that it intended to submit revised reports. We asked the State Controller to provide assistance to the Chancellor's Office so that it could finalize its financial reports in a timely manner. However, the State Controller accepted the estimated reports for inclusion in the State's CAFR, and was not concerned that these reports were not final and that the Chancellor's Office had submitted them without completing its process of reconciling them to supporting information. (2)

Throughout December 2018 and into early January 2019, we kept the State Controller apprised of the Chancellor's Office's efforts to finalize its financial reports. However, each time we spoke to the State Controller it simply reaffirmed its acceptance of the estimated reports. Consequently, we had to schedule and facilitate a meeting with the Chancellor's Office and the State Controller on January 23rd, 2019 to discuss the Chancellor's Office's progress toward revising its financial reports. We facilitated a similar meeting again on March 7, 2019 that was attended by Finance and the State Controller. The Chancellor's Office subsequently submitted updated financial reports on March 22, 2019. As discussed in our 2018-2 finding, the Chancellor's Office's use of estimated and unreconciled reports and late submission of its revised year-end report package delayed the completion of our audit procedures and the State Controller's finalization of the State's fiscal year 2017–18 CAFR.

The State Controller did not provide us with Finance's initial allocation in April 2018. In fact, the State Controller was still working with Finance in July 2018 to revise the initial allocations to incorporate new information on past contributions that it had recently provided to Finance. Two months later, in September 2018, the State Controller asked Finance to revise the allocation methodology to align with the method that it uses to allocate pension liabilities to various funds. It is our understanding that Finance had to revise these allocations multiple times because the State Controller did not provide timely information to Finance. On October 2, 2018, we asked for a copy of the allocation, however, both the State Controller and Finance stated the allocation was not ready for our review. Ultimately, Finance provided the initial allocations to us on November 20, 2018. (3)

However, Finance's allocations were still not final at this time because of disagreement over the California State University's (CSU) allocation. In January 2019, we facilitated a meeting attended by the State Controller, Finance, the CSU and its auditor where CSU discussed its disagreement with its allocation. Finance revised the allocation in February 2019 to settle this disagreement. Around this same time, we also had to have discussions with the State

Controller and Finance regarding the proper accounting treatment of a pending request for federal reimbursement for a portion of the contribution to CalPERS. This issue was also resolved in February 2019.

Finally, the State Controller also had to perform a separate allocation exercise to determine which state funds financed the pension contributions through a number of interfund loans. The State Controller did not provide us with these additional allocations until March 13, 2019. In addition, our review of this information was slowed because the State Controller's Technical Advisor was out of the office for a portion of this time period and no one could answer our questions in her absence. Furthermore, the State Controller's internal review of these complex allocations was inadequate. As a result, we identified an error that required the State Controller to revise the allocations in May 2019.

④ We find the State Controller's representation of this issue troubling because it does not acknowledge its responsibility for preparing a CAFR for the State of California that is fairly presented in accordance with GAAP. In October 2018, the State Controller sent a letter to the Office of the Attorney General (Attorney General) requesting certain information on pending litigation. The State Controller requests this information every year and relies on it to comply with GAAP reporting standards, which then serves as our evidence under generally accepted auditing standards. In November 2018, the Attorney General provided a response to the State Controller that warranted further clarification because it was difficult to determine the impact of numerous lawsuits on the State's CAFR from the language the Attorney General used. Rather than simply contacting the Attorney General to clarify the meaning of the pertinent language, the State Controller interpreted the language based on a flawed assumption. We did not believe this was appropriate, and we encouraged the State Controller to contact the Attorney General to obtain clarity. However, over the next several months the State Controller did not make sufficient efforts to resolve this. Consequently, we had to schedule a meeting with the Attorney General on May 1, 2019 to resolve this issue so that we could determine how these lawsuits should be reported in the CAFR. During this meeting, the Attorney General confirmed that the State Controller's interpretation of the language in its initial letter was incorrect. Although the State Controller attended this meeting as well, it did not participate in the discussion.

⑤ The State Controller implies in its response that we delayed its work on capital assets, which is not accurate. We received initial capital assets information from the State Controller in November 2018. We then reviewed this information and noticed that it included a significant restatement of the Department of Parks and Recreation's (State Parks) prior year capital assets balances. We expressed certain concerns to the State Controller regarding the validity of the restatement later that same month. From that point through February 2019, the State Controller worked unsuccessfully with State Parks to try to determine the appropriateness of the restatement. During that time period, the State Controller also provided us with revised capital assets information in January 2019 that excluded the effects of the restatement.

Because the State Controller was unable to determine the appropriateness of State Park's restatements of its prior year capital assets balances, we had to intervene by facilitating a meeting with the State Controller and State Parks to try to resolve the issue on March 5, 2019. After this meeting, the State Controller continued to rely on our assistance in determining whether this restatement was appropriate. We worked directly with State Park's accounting staff and ultimately confirmed that the restatement was not valid. Because the revised capital assets

information that the State Controller prepared in January 2019 already excluded the effects of this invalid restatement, we don't believe that it needed to wait until May 2019 to complete its remaining work on capital assets.

⑥ The State Controller mischaracterizes what we said in our report. As we state on page 7, it chose a method for allocating OPEB liabilities to state funds in a manner that is inconsistent with how the State pays for these benefits, creating the risk that a material misstatement to the State's CAFR could occur. Although we asked the State Controller to provide us with an analysis demonstrating that its methodology would not cause a material misstatement to the CAFR, it did not provide this information. Consequently, we had to perform this analysis. Although we found that the State Controller's allocation method did not result in a material misstatement to the 2017–18 CAFR, the risk remains for future years if it does not change its methodology to better align with the State's method of paying for OPEB benefits. We clearly describe this on page 7 of our report.

⑦ GASB 75 was issued in June 2015, thus we believe the State Controller had ample time to develop a sound approach for implementing this accounting and financial reporting standard.

⑧ The State Controller mischaracterizes the nature of our meeting in April 2018. This meeting was simply an entrance conference, in which we discussed the general scope and timeline of our audit of the OPEB report. The State Controller did not provide us any information before or during this meeting that would have enabled us to comment on its proposed allocation methodology. In addition, if the State Controller was working with its actuary and accounting consultant to develop its allocation methodology since October 2016, it should have engaged us in these discussions.

⑨ The State Controller is mischaracterizing the information it provided to us in August 2018 and our subsequent response. By this time, more than three months had passed since our entrance conference with the State Controller and we had not received any information detailing its allocation methodology, underlying rationale, or key assumptions. In response to our repeated requests for this information, the State Controller provided us with a two-page document that it intended to send to departments as a general introduction to the proposed methodology. During our next bi-weekly meeting, we asked the State Controller what type of feedback it wanted from us given that this information was not intended for us and was too generic for our use. The State Controller stated it simply wanted to know whether we believed sending this information to departments was a good idea. We affirmed that sharing this general information with departments was fine if it intended to split the OPEB liability based on active and retired members. However, at that point, we could not offer an opinion on any such split because the State Controller had not provided us sufficient information to do so.

⑩ We did not provide the State Controller any feedback pertaining to a "hybrid" group. As we describe on page 7, the State Controller provided us with partial information on its allocation methodology in September 2018 and followed up with additional information in late October 2018. We reviewed the State Controller's methodology and relayed our concerns and some questions that the State Controller could not answer. In response, the State Controller initially agreed to consult with its actuary about some of our questions, but subsequently decided that this was not necessary because the method of allocation was an "accounting decision." However, given the significance of our questions, we insisted that the State Controller consult with its actuary before moving forward with its proposed allocation methodology.

Subsequently, in late November 2018, the State Controller told us that it had spoken to its actuary, but it did not relay to us the details of that conversation. Instead, we were told that its proposal to split the liability had become "burdensome, unduly complex, and expensive". At that point, the State Controller decided that the method of allocation would be based solely on pensionable compensation.

(11) The State Controller refuses to accept responsibility for not implementing a major new accounting and financial reporting standard for OPEB in a timely manner and instead seeks to blame us. GASB 75 was issued in June 2015, thus we believe the State Controller had ample time to develop a sound approach for implementing this standard. Notwithstanding, between the months of June and September of 2018 the State Controller developed four different timelines for its OPEB report because it continued to miss deadlines for providing us with information. During our bi-weekly meetings, the State Controller was unwilling to share its reasons for missing its own deadlines, and its response similarly does not provide any clarity on that issue.

In addition, we did not hinder the State Controller's progress in publishing its OPEB report. Rather, it was the State Controller's poor project management that delayed its publication of that report. Furthermore, the State Controller's various attempts in its response to quantify average turnaround times for our "formal" feedback are misleading and disingenuous. We provided timely feedback to the State Controller during our bi-weekly meetings, numerous ad-hoc meetings, through emails and phone calls, and through its more formal "transmittal process". The statistics that the State Controller cites are meaningless because they do not accurately account for transmittals for which we provided our feedback using one of the informal mechanisms discussed above, transmittals that were incomplete for which we had to request additional information that delayed our ability to complete our audit work and provide a response, and transmittals that did not require a response from us.

It is true that we did not "formally" return the transmittal related to the State Controller's pro rata methodology and allocation calculations that it mentions in its response. However, it was not necessary for us to do so because this information was no longer pertinent to the OPEB report because the State Controller had decided not to use that allocation methodology. Notwithstanding, we did review that methodology and had several discussions with the State Controller on that topic prior to the State Controller's decision to abandon that method. Ultimately, we provided timely and substantive feedback to the State Controller on each piece of information that was pertinent to the OPEB Report.

(12) We reviewed the State Controller's initial allocation methodology and provided timely constructive feedback, which included a number of questions that the State Controller could not answer. Contrary to the State Controller's statement in its response, we did not reject its proposed methodology. Rather, we strongly recommended that the State Controller discuss our concerns and questions with its actuary. Subsequent to speaking with its actuary, the State Controller decided not to adopt its initial methodology and instead decided to use a method based entirely on pensionable compensation.

(13) The State Controller's method of allocating OPEB liabilities to state funds based solely on pensionable compensation is flawed because it does not align with the State's primary method of paying for these benefits, which is the pay-as-you-go method. In December 2018 we facilitated a meeting with the State Controller, its actuary and accounting consultant, and our actuarial consultant to resolve our outstanding concerns with the State Controller's initial

allocation methodology and to discuss other potential methods. Our actuarial consultant presented an alternative approach that took into account both types of contributions, which would better align with how OPEB liabilities will actually be paid; and information needed to implement this methodology is available now. Specifically, actual pay-as-you-go contribution amounts are available and prefunding contributions can be reasonably estimated based on pensionable compensation. Although the State Controller's actuary agreed that this alternative approach was reasonable, the State Controller instead decided to use an allocation methodology that is based solely on pensionable compensation.

Furthermore, the State Controller's statement that prefunding contributions and investment earnings thereon represent the State's strategy to reduce the net OPEB liability is not entirely accurate. Although prefunding is one strategy for reducing this liability, the State's primary method of funding this liability is by paying OPEB benefits as they become due using the pay-as-you-go method.

(14) The State Controller was never able to demonstrate the reasonableness of its initial allocation methodology therefore, we don't see any value in comparing those results to allocation results based on pensionable compensation. Nor is it clear what the State Controller means by "in most cases" the differences between the two methods were not significant.

(15) Because the State Controller did not invite us to participate in its discussions with departments and their external auditors, we subsequently contacted some of these auditors to discuss the impact the revised allocation methodology would have on departments' stand-alone financial statements. We found that these auditors generally shared our concerns with the State Controller's approach, and preferred an allocation methodology that is consistent with the manner in which contributions are made to the plan as mentioned in the cost sharing guidance of GASB 75. Although the State Controller was adopting a method that excluded the primary contribution type (pay-as-you-go), these auditors provided feedback to the State Controller that was focused on whether the resulting misstatements would be material to the stand-alone financial statements of their respective client departments.

(16) The State Controller's statement that its approach did not cause a material misstatement to any state fund is not true. Its allocation methodology initially caused a material misstatement to the Inmate Welfare Fund, and it had to post an accounting entry to correct this misstatement in May 2019.

(17) The State Controller's statement that none of the externally audited agencies received a modified opinion pertaining to its OPEB allocations is misleading. Even if these auditors had concerns with the State Controller's methodology, as several of them told us they did, they would have only issued modified opinions if the method resulted in material misstatements of the respective departments' stand-alone financial statements.

(18) The State Controller's method of allocating OPEB liabilities to state funds based solely on pensionable compensation is flawed because it does not align with the State's primary method of paying for these benefits, which is the pay-as-you-go method. Our actuarial consultant presented an alternative methodology that took into account both types of contributions (pay-as-you-go and prefunding), which would better align with how OPEB liabilities will actually be paid; and information needed to implement this methodology is available now.

As we state on page 7, the State Controller chose a method for allocating OPEB liabilities to state funds in a manner that is inconsistent with how the State pays for these benefits, creating the risk that a material misstatement to the State's CAFR could occur. Although we asked the State Controller to provide us with an analysis demonstrating that its methodology would not cause a material misstatement to the CAFR, it did not provide this information. Consequently, we had to perform this analysis. Although we found that the State Controller's allocation method did not result in a material misstatement to the 2017-18 CAFR, the risk remains for future years if it does not change its methodology to better align with the State's method of paying for OPEB benefits. (19)

The State Controller's response fails to acknowledge its responsibility for the preparation and fair presentation of the State's financial statements in accordance with GAAP. The State Controller is also required to provide us access to all information, of which it is aware, that is relevant to its preparation and fair presentation of those statements. Moreover, the State Controller sent us signed representation letters affirming that all information required by GAAP was in fact included in the CAFR during each of the years that it omitted the net pension liability, related amounts, and disclosures for trial courts. (20)

Notwithstanding, the State Controller acknowledges in its response that it has been aware of this omission since it implemented GASB 68 for fiscal year 2014–15. However, the State Controller failed to share this information with us until August 2018, when it was in the early stages of preparing the CAFR for fiscal year 2017–18. Since then, the State Controller has continued to change its explanation as to why this information was previously omitted from the CAFR. Our audit process relies on open and honest communications, an expectation that we communicate to the State Controller every year in our engagement letter. The State Controller's decision to withhold this information from us compromised the effectiveness of our audit.

The State Controller provides a number of different explanations for omitting the net pension liability, related amounts, and disclosures for trial courts from its past CAFRs. As we state on page 8, the chief of the State Controller's State Accounting and Reporting Division told us that the State Controller made this decision because the State does not issue paychecks to trial court employees through its centralized payroll system. In its current response, the State Controller also argues that relevant legislation did not indicate whether the State or the counties would be responsible for reporting pension related information for the trial courts. In addition, the State Controller mentions that other factors, such as how the plans are administered, also contributed to its decision to exclude this information from past CAFRs. As we explain on page 8, the State Controller should have made its decision on whether to include pension information for the trial courts in the State's CAFR, based on whether the courts are considered to be part of the primary government using the specific criteria contained in GAAP. (21)

The State Controller asserts in its response that the question of how to properly report pension information for the trial courts is a complex issue. However, there is no indication that the State Controller sought legal assistance on this matter until we recommended it do so in the fall of 2018. The State Controller also attempts to justify its earlier decision to not include pension information for the trial courts in the State's CAFR because there was no clear indication that counties would not report this information in their own financial statements. However, we believe that the State Controller should have been more proactive and spoken to the counties during its implementation of GASB 68 to determine whether they were planning to report this information, rather than waiting several years to notice that the counties were not doing (22)

this. Finally, as the preparer of the State's financial statements, the State Controller should have been able to identify the appropriate criteria in GAAP for deciding how to treat trial court pensions when it incorporated the requirements of GASB 68 into its fiscal year 2014–15 CAFR.

㉓ The State Controller's response fails to acknowledge its responsibility for the preparation and fair presentation of the State's financial statements in accordance with GAAP. The State Controller is responsible for determining the information and documentation that it needs to properly incorporate the net pension liability, related amounts, and disclosures for the remaining trial courts into future CAFRs.

㉔ The State Controller refuses to accept responsibility for not implementing a major new accounting and financial reporting standard for OPEB in a timely manner and instead seeks to blame us. We provided technical advice and timely critical feedback to the State Controller throughout the audit, during bi-weekly meetings, numerous ad-hoc meetings, through emails and phone calls, and through its more formal transmittal process. On a number of occasions, we also helped the State Controller and various departments resolve different issues that arose during the audit. Notwithstanding, it is the State Controller that is responsible for the preparation and fair presentation of the State's financial statements in accordance with GAAP.

㉕ In May 2019, we received a phone call from the State Controller asking us to review a survey that it planned to send to departments as part of its implementation of GASB 87, which is effective for fiscal year 2020–21. The individual that called told us that we only had two days to provide our feedback or the State Controller's efforts to implement this new standard would be delayed. This was an unreasonable request, especially given that when we received this call all of our resources were focused on completing the fiscal year 2017–18 audit. Consequently, we responded that two days was not enough time for us to perform a proper review of this survey. We also recommended that this individual provide the survey using the State Controller's formal transmittal process because we wanted to ensure that this important survey was subjected to the State Controller's internal review process prior to being sent to us.

㉖ Our actuarial consultant presented the State Controller with an alternative allocation method that would better align with how OPEB liabilities will actually be paid; and information needed to implement this methodology is available now. Specifically, actual pay-as-you-go contribution amounts are available and prefunding contributions can be reasonably estimated based on pensionable compensation.

㉗ Although we asked the State Controller to provide us with an analysis demonstrating that its allocation methodology would not cause a material misstatement to the CAFR, it did not provide this information. We continue to believe that the State Controller should revise its allocation methodology to better align with the State's primary method of paying OPEB expenses, or develop a reliable mechanism for ensuring that the resulting misstatement to the State's CAFR does not become material.

DEPARTMENT OF FINANCE

Reference Number: 2018-2

Condition:

The Department of Finance (Finance) adopted a new policy in consultation with the State Controller that provided financial reporting instructions for fiscal year 2017–18 for those departments that have implemented the Financial Information System for California (FI$Cal). While the policy instructs departments to reconcile their accounting records to supporting information and to the accounts of the State Controller, it does not clearly require these departments to do so prior to submitting their year-end financial reports to the State Controller for its use in preparing the State's CAFR. These reconciliations constitute an important internal control because they enable departments to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's CAFR. However, when departments submit financial reports before completing these reconciliations, it increases the risk of a material misstatement to the State's CAFR. We discuss below one large department that did not complete its reconciliations prior to submitting its year-end financial reports to the State Controller.

The new policy also allows departments to submit estimated financial reports if they are unable to prepare actual reports using FI$Cal. GAAP does not allow for "estimated financial reports," but it does allow for financial statements that include estimates that are based on sound methodologies, and complete and accurate information. We are concerned that the policy as written may cause confusion and lead some departments to believe that it is permissible to submit estimated financial reports that may not contain accurate or complete information. The policy instructs departments submitting "estimated year-end reports" to complete and submit "actual year-end reports" at a later date. However, the policy does not specify when these revised reports are due and we believe this unnecessarily increases the risk that the State Controller will use estimated financial reports, which may be inaccurate or incomplete, to prepare the State's CAFR. In fact, according to the State Controller's records, 17 departments submitted estimated financial reports that were included in the CAFR. However, 16 of these departments did not pose a material risk to the State's fiscal year 2017–18 CAFR and we discuss the remaining department below. Finally, the policy does not include a requirement that departments include a trial balance for certain funds, including the General Fund, when they submit their estimated year-end financial reports to the State Controller. We believe departments' reporting packages should include a trial balance for all funds because this report can be used by us and the State Controller to assess the overall condition of a departments' accounting records.

One department that is of material importance to the State's overall financial reporting for fiscal year 2017–18 illustrates our concerns with Finances' new financial reporting policy for departments using FI$Cal. In October 2018, after the California Community Colleges Chancellor's Office (Chancellor's Office) had submitted estimated financial reports to the State Controller, we requested its trial balance and year-end reconciliation for the General Fund, and learned this information was not yet available. The director of accounting indicated she had not yet completed her reconciliations, and that the accounting records were not finalized. We followed up with the Chancellor's Office in January 2019, and although it had made some progress, it still had not completed its reconciliations and a trial balance for the General Fund

was still not available. On March 22, 2019, the Chancellor's Office submitted to the State Controller updated estimated financial reports, an estimated trial balance, and an estimated year-end report showing the reconciliation of its accounting records to the records of the State Controller. The Chancellor's Office has still not completed and finalized its year-end reconciliations and financial reports, in spite of the fact that the State Controller has already published the State's CAFR for fiscal year 2017–18. The Chancellor's Office's use of estimated and unreconciled financial reports and late submission of its revised year-end reporting package delayed the completion of our audit procedures and the State Controller's finalization of the State's fiscal year 2017–18 CAFR.

Criteria:

Government Code sections 13070, 13300, and 13310 assigns responsibility to Finance to set statewide accounting policies and procedures and to provide departments with accounting training, advice, and consulting services. The *State Administrative Manual* (SAM) contains the statewide accounting policies.

Government Code section 12460 assigns responsibility to the State Controller for issuing an annual CAFR that is prepared in accordance with GAAP.

SAM section 7901 states that departments are required to reconcile their account balances to supporting documentation to ensure the accuracy and completeness of posted transactions. Further, departments must complete reconciliations between their accounts and the accounts maintained by the State Controller to identify and correct errors. Departments must analyze differences and correct their accounts or request that the State Controller correct its accounts so that both sets of records agree. To ensure the accuracy of a department's financial reports any errors should be corrected before the financial reports are prepared. All reconciliations must be prepared monthly within 30 days of the preceding month, with the exception of property reconciliations.

Recommendations:

In order to improve internal controls over financial reporting, Finance should consult with the State Controller and revise its financial reporting policy for FI$Cal departments for fiscal year 2018–19 and do the following:

- Require departments to perform all relevant reconciliations prior to submitting year-end financial reports to the State Controller.
- Clarify that any accruals and underlying estimates are based on sound methodologies, and complete and accurate information, and remove any references to "estimated financial reports."
- Require departments to submit a trial balance for all funds as part of any year end reporting package submitted to the State Controller.

To mitigate the risk of the State releasing another late CAFR, Finance should consult with the State Controller and do the following:

- Ensure that departments adhere to the requirements of the revised policy discussed above and meet applicable deadlines for submitting year-end financial reports.

Department's View and Corrective Actions:

Finance shares the goal to produce accurate and complete annual financial reports. The additional policy guidance developed in consultation with the State Controller and State Auditor for 2017–18 was to ensure the state could meet this goal. Additionally, Finance provides ongoing training and consultation to state departments to assist with monthly reconciliations and year-end reporting. The process to update the policy guidance in consultation with the State Controller and State Auditor is underway and has already considered these recommendations. ① ①

Auditor's Comments on the Department of Finance's View

To provide clarity and perspective, we are commenting on Finance's response to our report. The numbers below correspond to the numbers we have placed in the margin of Finance's response.

① In August 2018, the Department of FI$Cal provided us with a copy of a new policy that provides financial reporting instructions for departments using FI$Cal. After reviewing this policy, we met with both Finance and the State Controller to discuss the policies' impact on our audit of the State's CAFR. Under the standards that govern our work, the setting of policies is the role of management, and as such, we did not participate in the drafting of this policy. However, we will continue to provide feedback to both Finance and the State Controller on the impact that any future policies may have on our audit of the State's CAFR.

DEPARTMENT OF HEALTHCARE SERVICES

Reference Number: 2018-3

Condition:

The Department of Health Care Services (DHCS) overstated Medi-Cal expenditures and revenues in the Hospital Quality Assurance Revenue Fund for fiscal year 2017–18 by $353.9 million and $466.1 million, respectively. DHCS also overstated expenditures and revenues in the Federal Trust Fund by $333.5 million across multiple programs and overstated expenditures in the General Fund by $191.2 million. Finally, DHCS understated revenues in the Global Payment Program Fund by $337.3 million. For budgetary purposes, DHCS reports Medi-Cal expenditures on a cash-basis. However, GAAP requires governmental funds to be accounted for on a modified accrual basis. Specifically, expenditures must be recognized in the period in which they are incurred and revenues must be recognized when they are available and measurable. Additionally, the related federal funding should be recognized when all applicable eligibility requirements, including time requirements, are met. 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 CAFR. The following sections provide more detail about DHCS' misstatements by program.

Overstated Accruals for the Hospital Quality Assurance Fee Program

DHCS overstated its Hospital Quality Assurance Fee (HQAF) program expenditure and revenue accruals in the Hospital Quality Assurance Revenue Fund by $353.9 million and $466.1 million, respectively. Additionally, DHCS overstated expenditures and related revenues for this program by $321.7 million in the Federal Trust Fund. Welfare and Institutions Code section 14169.52 imposes a quality assurance fee on certain hospitals in order to obtain additional federal money to fund supplemental payments to hospitals and payments for low-income children's health care coverage. Under the HQAF program, DHCS collects quality assurance fees from hospitals, matches these fees with federal funding, and then disburses both the quality assurance fees and federal funds back to hospitals as Medi-Cal payments. This program also reimburses the General Fund for health care related costs of low-income children. Multiple divisions within DHCS provide information needed to accrue the revenues and related expenditures for this program. DHCS did not properly prepare and compile this information resulting in a failure to properly match the accrual of program revenues to the related expenditures.

Overstated Accruals for the Specialty Mental Health Services Program

DHCS overstated expenditures and related revenues in the Federal Trust Fund by $486.9 million for the Specialty Mental Health Services (Mental Health) program. The Mental Health program provides specialty mental health services to Medi-Cal beneficiaries that meet certain medical necessity criteria. Due to the nature of this program, the invoicing and payment cycle can take up to three years. In preparing the accrual for fiscal year 2017–18, DHCS erroneously accrued expenditures for services provided during fiscal year 2016–17 even though DHCS had largely paid for these services by June 30, 2018.

Understated Accruals for the Medi-Cal Managed Care Program

DHCS understated expenditures and related revenues in the Federal Trust Fund by $475.1 million,and it overstated expenditures in the General Fund by $191.2 million, for the Medi-Cal Managed Care (Managed Care) program. Under the Managed Care program, DHCS pays managed care health plans a monthly amount for each enrolled member to provide health care services through established networks of organized systems of care, which emphasize primary and preventive care. The misstatement in the Federal Trust Fund occurred because DHCS did not have a process in place to update its initial revenue and expenditure accruals for significant changes in estimates and because the initial accounting entry was not compiled correctly.

Part of the misstatement in the Federal Trust Fund pertains to two new programs that the federal government approved during fiscal year 2017–18. These programs fund payments to managed care health plans for meeting certain performance metrics and additional payments to certain providers of contracted services. Furthermore, DHCS did not properly accrue amounts that managed care health plans were required to return to the federal government. Specifically, managed care contracts require health plans to spend a certain percentage of their monthly payments on allowed medical expenses for adults covered under the federal Affordable Care Act. Managed care plans that do not meet this requirement must return a portion of these payments. Finally, DHCS also overstated General Fund expenditures because it improperly classified expenditure reimbursements as revenues for the Managed Care program.

Understated Accruals for the Global Payment Program

DHCS understated revenues in the Global Payment Program Special Fund by $337.3 million for the Global Payment program. The Global Payment program streamlines funding to participating public health care systems for providing care to California's uninsured population and creates a mechanism to increase incentives for providing primary and preventive care and certain other services. DHCS omitted from its accrual the nonfederal share of revenues paid by participating health care systems as a condition for participating in the program.

Criteria:

California Government Code Section 12461 requires the State Controller to issue an annual CAFR that is prepared in accordance with GAAP. The State Controller 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).To prepare its CAFR, the State Controller 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 revenues to be reported when they become available and measurable, and expenditures to be reported when the related liability has been incurred except in certain limited circumstances.

Codification of Governmental Accounting and Financial Reporting Standards Section N50 states that for government-mandated non-exchange transactions, recipients should recognize revenues when all applicable eligibility requirements, including time requirements, are met. When the modified accrual basis of accounting is used, revenues resulting from non-exchange transactions should also be available.

Codification of Governmental Accounting and Financial Reporting Standards 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 in the reimbursed fund.

Recommendation:

To ensure that its financial statements are properly presented and in compliance with GAAP at fiscal year-end, DHCS should do the following:

- As applicable, develop or revise written procedures to ensure it correctly compiles information needed to prepare accruals for its various Medi-Cal programs.
- Revise existing written procedures to ensure it only accrues expenditures outstanding at year-end.
- Develop a process to update initial Medi-Cal accruals to account for significant changes in estimates.
- Provide guidance and training to staff to ensure that all accrual procedures comply with GAAP.

Department's View and Corrective Action:

DHCS agrees with the findings and will implement the following corrective actions:

- Align procedures to provide accurate GAAP accruals to the State Controller.
- Update existing procedures for calculating the accrual to ensure only outstanding expenditures at year-end will be reported to the State Controller as a GAAP accrual.
- Develop an internal process to update and inform the State Controller if significant changes are identified in initial accrual estimates. This process will include and not be limited to developing a material threshold to define "significant."
- Review guidance and training materials to ensure all accrual procedures comply with GAAP and provide additional training sessions and guidance to programs.

CALIFORNIA DEPARTMENT OF TAX AND FEE ADMINISTRATION

Reference Number: 2018-4

Condition:

The California Department of Tax and Fee Administration (CDTFA) did not complete bank reconciliations for the months of May and June 2018 in a timely manner. Specifically, CDTFA did not reconcile the $2 billion balance in its general checking account on May 31, 2018, or the $289.5 million balance in its general checking account on June 30, 2018, to the bank's records until December 2018. CDTFA also submitted certified year-end financial reports to the State Controller before performing these bank reconciliations. Promptly reconciling cash balances per its records to the bank's records is fundamental to CDTFA's ability to detect fraud or errors in its cash accounts. By failing to complete bank reconciliations in a timely manner, CDTFA was not able to ensure that the cash it received from taxpayers was properly recorded by its accounting department or by its bank in a reasonable timeframe, nor that the amounts it reported to the State Controller in its financial statements were accurate.

CDTFA was unable to perform bank reconciliations in a timely manner because of problems it had transitioning to a new accounting information system, the Centralized Revenue Opportunity System (CROS), which it began to use to administer some of its tax programs toward the end of fiscal year 2017–18. In May 2018, CDTFA transitioned its accounting for sales and use taxes to CROS while continuing to account for a number of other taxes it administers in the Integrated Revenue Information System (IRIS), its legacy system. Because CDTFA was using two accounting systems at the same time, it planned to have its field offices prepare separate deposit slips to identify the accounting system used to process the receipts. However, CDTFA did not ensure that this plan was fully carried out. CDTFA's chief accounting officer stated that some field offices combined receipts that were processed in the two accounting systems when depositing funds. Consequently, in order to later complete bank reconciliations, she said that CDTFA's accounting staff had to conduct research to vouch deposit slip information to daily cash reports from the two accounting systems, resulting in significant delays in completing the reconciliations.

Criteria:

SAM Section 8060 requires all centralized State Treasury System accounts to be promptly reconciled at the end of each month.

Recommendations:

To ensure that its bank reconciliations are completed in a timely manner and to facilitate the transition of additional types of taxes to its new accounting system, CDTFA should do the following:

- Update existing cashiering policies and procedures.
- Provide additional guidance and training to program and accounting staff.
- Improve internal communications among program and accounting staff.

Department's View and Corrective Action:

CDTFA agrees that bank reconciliations were not completed on time due to complications transitioning to CROS. In May 2018, CDTFA converted its sales and use tax programs to CROS, which affected not only how tax collections are posted, but also how they are processed. These changes led to delays, which CDTFA has been working diligently to correct.

CDTFA has already started to implement the California State Auditor's recommendations. Specifically, CDTFA has added staff resources to complete bank reconciliations and is working toward a daily reconciliation of deposits from field offices, which will facilitate a timely monthly bank reconciliation. CDTFA is also updating its cashiering policies and procedures to reflect these changes. In addition, accounting and program staff are engaged in user-acceptance testing and system enhancements to CROS. The accounting team has also recently started a training session three times per week with CROS specialists to ensure fluency in the system and related processes. Furthermore, CDTFA recently created an executive role to head Compliance in the Field Operations Division. The new executive will serve as a single point of contact for all compliance matters, including cashiering. The accounting team also participates in bimonthly meetings with the Field Operations Division as well as CROS representatives to communicate and address issues that involve field offices.